BANKING LAW & PRACTICE

SECOND YEAR B.A. Programme

Semester – 4

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B.A. SECOND YEAR

Semester – 4 : BANKING LAW & PRACTICE

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining a 'A' Grade from the NAAC in the year 2014, the Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 285 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education with the aim to bring higher education within reach of all. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even housewives desirous of pursuing higher studies. With the goal of bringing education in the door step of all such people. Acharya Nagarjuna University has started offering B.A, and B, Com courses at the Degree level and M.A, M.Com., L.L.M., courses at the PG level from the academic year 2021-22 on the basis of Semester system.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers invited respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn facilitate the country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Coordinators, Editors and Lesson -writers of the Centre who have helped in these endeavours.

Prof. P.Rajasekhar
Vice –Chancellor,
Acharya Nagarjuna University

415BAN21 -BANKING LAW AND PRACTICE

IV SEMESTER

Syllabus

UNIT –I:

Definition of Banker and Customer – Relationship between Banker and Customer – General and Special features of Relationship.

UNIT-II:

Opening of Accounts – Special types of Customers like minors, married women, partnership firms, companies, clubs and other non-trading institutions.

UNIT – III:

Negotiable instruments – Descriptions and their special features – Duties and responsibilities of paying banker and collecting banker – Circumstances under which a banker can refuse payment of cheques – Consequences of wrongful dishonor.

UNIT – IV:

Precautions to be taken while advancing loans against securities – Goods Documents of title to goods – Loans against real estate – Insurance policies – against collateral securities – Bankers Receipts.

UNIT – V:

Rule in Clayton's case – Garnishee Order – Loans against equitable mortgage and legal mortgage and distinction between them – Latest trends in Deposit mobilization.

Reference Books:

1. Banking Theory and Law & Practice, S. N. Maheswari & R. R. Paul
2. Banking Law and Practice, Kalkundrikar, Kembhavi, Nataraj – Himalay Publishing House.
3. Control of Commercial Banks in India, Dr. Mohammad Quddus.

MODEL QUESTION PAPER (415BAN21)

B. A. Degree Examination

Second Year – Fourth Semester

Part – II : Banking

Paper – V : BANKING LAW AND PRACTICE

Section – A

Answer any FIVE of the following questions [5 × 4 = 20 MARKS]

1. Define Banker and Customer.
2. Minor customer.
3. What are non trading institutions?
4. What are negotiable instruments?
5. Bankers Receipts.
6. Loans against real estate.
7. Define Clayton's case.
8. Garnish order.

Section – B

Answer the following questions [5 × 10 = 50 MARKS]

9. a) What is the relationship between Banker and Customer?

(Or)

b) General and special features of relationship between Banker and Customer.

10. a) What are the different types of Customers?

(Or)

b) What are rules for partnership firms to opening of accounts?

11. a) Duties and Responsibilities of Paying Banker.

(Or)

b) What are the Circumstances under which a banker can refuse payment of cheques?

12. a) What are the precautions to be taken while advancing loans against securities?

(Or)

b) What are the Precautions to be taken Loans against real estate?

13. a) Write about the differences between equitable mortgage and legal mortgage.

(Or)

b) Latest trends in Deposit mobilization.

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	7	Collecting Banker	7.1 - 7.10
	8	Dishonour of Cheque	8.1 - 8.12
Unit – 4	9	Loans and Advances	9.1 - 9.26
	10	Advancing Loans against Securities	10.1 - 10.16
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	12	Mortgages and Deposits	12. 1 - 12.14

LESSON – 1

RELATIONSHIP BETWEEN BANKER AND CUSTOMER

Objectives :

- To know the meaning of Banker and Customer
- To understand the general relationship between banker and customer
- To understand the special relationships between banker and customer in various capacities

Structure of the Lesson :

1.1 Introduction

- 1.1.1 Indian scenario
- 1.1.2 Indian banking system
- 1.1.3 Meaning of banker

1.2 Definition of "Banking"

1.3 Principles of Banking

1.4 Definition of the word customer

1.5 Banker and customer relationship

- 1.5.1 Debtor – Creditor
- 1.5.2 Trustee – Beneficiary
- 1.5.3 Agent Principal
- 1.5.4 Bailor – Bailee
- 1.5.5 Assignor – Assignee

1.6 Rights of Banker

1.7 Duties of a Banker

1.8 Banker customer relationship

1.9 Conclusion

1.10 Summary

1.11 Key words

1.12 Self Assessment Questions

1.13 Suggested books

1.1 INTRODUCTION :

The word "Bank" is derived from an Italian word "Banco" which means "a bench", on which money changers sat and did their business in ancient days.

In 1587	–	"Banco de Rialto" was first set up in Venice
In 1609	–	Bank of Amsterdam was set – up
In 1619	–	"Banco Del Giro" took over "Banco de Rialto"
In 1694	–	Bank of England was set up and became as Central Bank of the country

1.1.1 Indian Scenario :

In 1786	–	The Indian Banking History started with establishment of "General Bank of India", followed by "Bank of Hindustan" and "Bengal Bank"
In 1809	–	Presidency Bank of Bengal was established
In 1840	–	Presidency Bank of Bombay was established
In 1843	–	Presidency Bank of Madras was established
In 1934	–	Reserve Bank of India was formed by passing RBI Act, 1934. RBI was Nationalized on 1st January, 1949 by passing Transfer of Public Ownership Act
In March 1949	–	Banking companies Act was passed, which gave more powers to RBI (to control the working of Commercial Banks)
In 1955	–	The Imperial Bank of India was nationalized and came into existence as "State Bank of India". Then seven subsidiary banks, for State Bank, were set up and they together were called by the name "SBI Group"
On 19th July 1969	–	14 major Scheduled Banks in the country were nationalized [Scheduled Commercial Bank is one which is included in the 2nd schedule of RBI, Act]
In 1980	–	Six more commercial banks were nationalized

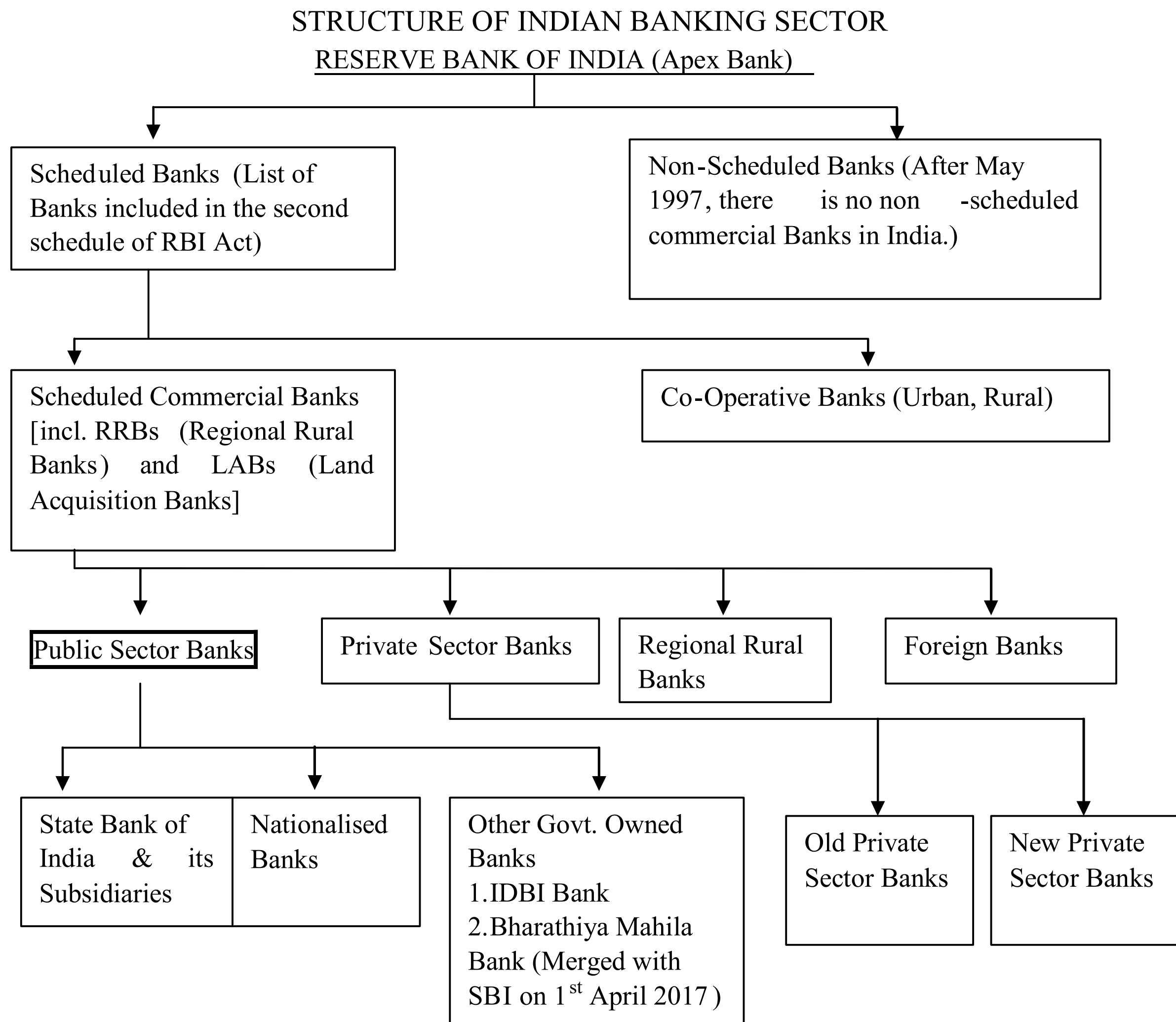
Now, India is having 21 public sector Banks, the latest, "India Post Payments Bank", established on 1st September 2018 in New Delhi and the Government has 100% stake in it.

There are 22 Private Sectors Banks functioning in our country, the latest two (a) Bandhan Bank, established in 2015 at Kolkata, West Bengal. (b) "IDFC First Bank" in 2015 at Mumbai, Maharashtra.

46 Foreign banks are also operating in India, now.

1.1.2 Indian Banking System :

Indian Banking system is a Branch Banking system, regulated by the Reserve Bank of India as the apex banking authority in the country. It is patterned on British Banking system, having 'Bank of England' as the banking regulator.



1.1.3 Meaning of "Banker" :

The words "Banker" and "Bank" are used interchangeably. The Cambridge dictionary says the word 'Bank' means "ability to pay" as opposite to the word "bankrupt" which means "inability to pay".

According to Dr. Herbert L. Heart "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".

According to Sir John Paget "No person or body corporate or otherwise can be a banker who does not,

1. accept deposit account
2. accept current accounts
3. issue and pay cheques and
4. collect cheques crossed or uncrossed for his customers.

From these definitions, we can arrive at a common concept of banking. Accordingly a banker is one who

a) accepts deposits

b) grants loans and undertakes investments.

Before understanding the complete meaning of the word "Banker", first we have to understand the meaning of the word "Banking", also.

1.2 DEFINITION OF "BANKING" UNDER INDIAN LAW :

In India, 'banking' has been defined by Banking Regulation Act, 1949 (vide Sections 5b, c) as follows :

- Accepting, for the purpose of lending (or)
- Investment of deposits of money received from the public
- Repayable on demand and
- Withdrawable by cheque, draft, order or otherwise [Section – 5(b)]

A Banking company is "a company which transacts the business of banking in India" [section 5 (c)].

From the above definitions, we can understand that the following are the core functions a bank.

- Acceptance of Deposits from the public.
- Making deposits of customers with drawable by cheque or otherwise (Withdrawal slip, letter, voucher etc) on demand or repayable on maturity to the customers.
- Lending or investing funds collected from customer, subject to the obligation to repay the deposits to the customer on demand or otherwise as per the term of the deposits.

To execute the above functions, in a complete and excellent way, banks follow some suitable and prudent policies which are given below :

1.3 PRINCIPLES OF 'BANKING' :

Principle of Intermediation :

Banks are called financial intermediaries, as they mediate between the depositors (savers of money) and borrowers (users of money). Banks invest or lend funds of depositors who themselves are unable to lend their funds, due to risk. Banks have expertise and abilities to manage such risks.

Principle of Liquidity :

The simultaneous operations of accepting the deposits (repayable on demand or on certain maturity periods) and lending these funds to borrowers in a manner such that the bank would be able to arrange for the funds, without interruption.

Principle of Profitability :

Banking business, like any other, aims at profit in order to sustain the required growth. The banks earn profit by way of interest income (interest on loans and investments and fee based income, charges of various kinds, commission etc).

Interest Income :

The differential spread of interest between loans and deposits rates, is the "interest income". It is the main source of profit for a bank. The interest earned by a bank on its lending operations should be higher than the interest paid by it on its deposit operations.

Non-Interest or fee – based income :

Non – Interest income is earned by banks by way of commission on issue of drafts, letters of credit, funds remittance, foreign exchange business and other ancillary services.

Principle of Solvency :

Banks plough back a good portion of their profits into their business to enhance the reserves and financial strength of banks. It is also essential for compliance of the regulatory guidelines regarding Capital Adequacy Ratio, asset classification and provisioning for nonperforming assets etc. This is the principle of solvency, which also enables liquidity and profitability.

Principle of Trust :

The Principle of Trust indicates the "confidence or dependability" as perceived by customers and public in relation to a bank.

The public confidence in a bank arises from the cumulative result of the policies of liquidity, profitability, solvency and governance quality followed by each bank over a long period.

In the light of these principles we shall analyse the relationships between a "Banker" and customer.

1.4 DEFINITION OF THE WORD "CUSTOMER" :

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

a) A customer is one who deals with the bank

b) The dealing of the customer must be in the nature of regular banking business

There is no statutory definition of the term 'Customer' in India under Banking Regulation Act, 1949 or and other relevant Act. We have to look to the judicial pronouncement for its definition. For example, the judgement pronounced in the Great Western Railway Co vs. London and County Banking co ltd., (1901 A.C414) defines a customer as follows :

"A customer is a person who has some sort of account, either deposit or current account or some similar relations with a bank. From this, it follows that any person may become a customer by opening a deposit or current account or similar relation with a bank".

The above judgement has been also followed by Indian Courts as regards the meaning or essential elements of a customer. By opening a Bank account Current, Savings, Fixed Deposit etc., in one's name and by depositing required money in such an account, a person becomes the customer of that particular branch of the bank.

Once a person becomes customer, the relationship between the Bank and Customer gets started legally and may take different forms, depending upon the type of banking services the customer is availing from the bank.

1.5 BANKER – CUSTOMER RELATIONSHIP :

The main relationship between bank and a customer is that of debtor -creditor in the case of deposit account and creditor – debtor in the case of overdraft or loan account. The bank acts trustee in case of valuables entrusted with the bank branch and as agent or bailee in other kinds of transactions. These kinds of relationships enjoin different rights and duties on the bank, involving different degrees of care and diligence as below:

The Relationship between banker and customer can be in the form of

1.Debtor – Creditor
2.Trustee – Beneficiary
3.Agent – Principal
4.Bailor – Bailee
5.Assignor – Assignee

1.5.1 Debtor – Creditor :

A debtor is an entity that owes a debt to another entity. The entity may be an individual, a firm, a government, a company or other legal person. The counter party a creditor. When the counterpart of this debt arrangement is a bank, the debtor is more often referred to as a borrower.

a) Bank as debtor :

The principal relationship of bank-customer is that of debtor-creditor in case of deposit accounts like Savings Bank account, Current account, Fixed Deposit account and Recurring Deposit account.

b) Bank as creditor :

The relationship between bank-customer becomes that of creditor-debtor, when customer has borrowed money from the bank by way of OD(Overdraft), CC(Cash credit), Demand loan, Term loan, Bills discount or any other kind of loan or advance, either on secured or unsecured basis.

According to Sir John Paget, "the relationship between banker and customer is primarily that of a debtor-creditor and the respective position is determined by the state of the account". This means when a banker receives deposit from a customer, if the deposit is to the credit of the customer, the banker becomes a debtor and the customer creditor. Thus, in all savings account where the customer's account is in credit balance, the banker is the debtor and the customer, creditor.

DIFFERENCE BETWEEN NORMAL DEBTOR – CREDITOR RELATIONSHIP AND BANKER – CUSTOMER RELATIONSHIP :

Normal	Banker – Customer
Debtor makes repayment of Debt even without demand from creditor.	Only when the customer demands payment through presentation of a cheque, the Banker makes payment.
Interest rate is normally decided by the creditor	Interest is decided by the debtor, the banker
Creditor can demand repayment of loan at any time / moment.	Customer as a creditor has to demand only during the working hours of the bank.
Creditor can make oral (or) written demand.	Customer should demand in the proper manner by the presentation of cheques or withdrawal slip or any other mode as prescribed by the Bank.
According to law of limitation, the repayment should be done by the debtor within three years from the date of loan.	Here, the law of limitation commence from the date of demand made by the customer on his Deposit.

1.5.2 Trustee – Beneficiary :

Trustee is an individual who is responsible for a property or an organization on behalf of some other individual or a third party. Trustee is supposed to make profitable decision for the entity under it authorization. It is a legal relationship between the trustee and the party, where the trustee is totally responsible for the maintenance, performance, and profitability of the trust under his guidance.

A beneficiary is any person who gains an advantage and/or profits from something.

This relation works out when the,

- Customer deposits money for a specific purpose, the banker is a trustee and the customer beneficiary. As such, the banker has to employ the funds for a specific purpose for which it is meant.
- Banker becomes a trustee whenever he undertakes to collect cheques on behalf of customers. After realizing, banker has to credit the proceeds to the account of the customer. When the amount is credited to the account of the customer, the relationship changes wherein the banker becomes a debtor and the customer creditor.
- Customer deposits securities and valuables for safe custody with the banker. The banker in such a case is a trustee and so, whenever the customer demands the securities, the banker has to return them to the customer who is a beneficiary.
- In the case of companies, when they receive debenture amount from the public, the banker acts as one of the trustees of the company and so has a responsibility to review the value of the assets against which the debentures are issued. Hence, the banker has a responsibility to supervise the property of the company for which he is a trustee.

1.5.3 Agent – Principal :

An agent is a person who acts for or represents another.

The principal is the person who gives authority to another, called an agent, to act on his or her behalf.

Banker acts as an agent of a customer, when

- Purchasing and selling securities on behalf of the customers
- Collecting dividend warrants and interest warrants
- Paying club subscription, insurance premium, rent and other bills, as per instruction of the customer

Here again, the relationship cannot be called in the true sense as agent – principal. In the case of a normal agent-principal relationship, the agent has to render accounts to the principal and should also inform the principal how the amount given to him by the principal

has been spent or invested. In other words, the agent has to render accounts to the principal while dealing with the funds of the principal.

However in the case of a banker – customer relationship, though the banker is dealing with the money belonging to the customer, he need not render accounts to the customer or inform the customer as to how the money is lent or invested. Though the money invested or lent, belong to the customers the banker need not tell them the extent of profit or return he made from such investment or loan. But in the case of normal agent – principal relationship, it is the duty of the agent to render accounts to the principal and also inform the return earned on the investment. Thus, though a banker may act as an agent of customer, in the true legal sense, he is not an agent and so he need not render account for the money deposited with him.

1.5.4 Bailor – Bailee :

A bailor is a person who entrusts a piece of his or her property to another person (the bailee). A bailee does not have ownership of the property.

When a customer borrows from a bank against the security under pledge, the bank is regarded not only a pledgee but also a bailee and so the bank has to take care of the security until it is returned to the customer. But the goods kept in the safe deposit vault will not come under bailment. The customer is keeping the goods in the safe deposit vault secretly and hence the banker will not be a bailee. As a bailee, the goods coming into his custody will be protected and the banker is totally aware of the nature of the goods. Thus, the banker will act as a bailee only when goods are entrusted to him for a specific purpose. Any expenses incurred towards maintenance of the security or goods have to be borne by the customer.

1.5.5 Assignor – Assignee :

An assignor is a person who transfers property rights or powers to another. An assignee is a person or entity to which property rights or powers are transferred. An assignee is the one to whom assignments are made.

Whenever a bank gives loan against life insurance policy or book debts or supply bills, the banker is the assignee and the customer the assignor. Under assignment, the actionable claim of the customer is transferred to the bank as security for loan. Thus, assignment is done by customers whenever they take loan against insurance policy or book debts. Even contractors after undertaking public works for the government, obtain loan from the bank by assigning the supply bills in favour of the bank.

1.6 RIGHTS OF BANKER :

Right of set – off :

A debtor can recover any debt due from a creditor before settlement of debt with the creditor. This is called “Right of set-off”

- When a bank accepts deposit from customer, he is a Debtor
- When a bank lends money to the customer, the banker is a creditor and customer becomes Debtor.
- In this situation, if the customer approaches the bank for closing his deposit account, the bank will allow the customer to close the account only after recovering the loan taken by the customer, from his deposit money

Three conditions are to be fulfilled to exercise right of set – off

a) The same customer should have the deposit account and loan account

b) The loan must be outstanding and overdue when the loan amount is not overdue, the right of set – off can not be exercised.

c) There should not be any agreement between the banker and customer, by which the banker is prevented from exercising right of set – off.

Right of set – off can be exercised when a partner's individual account has a credit balance and the firm's account has a debit balance, due to loan taken from bank. But vice-versa can not be done.

Right of Lien:

Lien is a right of a banker, by which he can retain any security coming to his possession for the purpose of any loan due by customer.

Banker's right of general lien :

One of the important rights enjoyed by a banker is the right of general lien. Lien means the right of the creditor to retain goods and securities owned by the debtor until the debt due from him is paid. It may either be general or particular. Bankers most undoubtedly have a general lien on all securities deposited with them as bankers unless there is an express or implied contract inconsistent with lien. In India sec 171 of the Indian Contract Act confers general lien upon bankers as follows – Bankers may in absence of a contract to the contrary, retain as security for a general balance of account, any goods bailed to them.

Circumstances for exercising general lien :

1) No agreement inconsistent with the right of lien.
2) Property must be possessed in his capacity as a banker.
3) Possession should be lawfully obtained.
4) Property should not be entrusted to the banker for a specific purpose.

Incidents of lien – lien attaches to

1) Bills of exchange or cheques deposited for collection or pending discount.

2) Dividend warrants and interest warrants paid to the banker under mandates issued by the customer.

3) Securities deposited to secure specific loan but left in banker's hand after loan is repaid.

4) Securities, negotiable or not, which the banker has purchased or taken up, at the request of customer, for the amount paid.

***Exceptions* – banker has no general lien :**

1) On safe custody deposits.
2) On securities or bills of exchange entrusted for specific purpose.
3) On articles left by mistake or negligence.
4) On deposit account.
5) On stolen bond.
6) Until due date of the loan.
7) On trust account.
8) On title deeds of immovable properties.

Right of appropriation is a right exercised by a creditor upon his debtor for the purpose of setting loan account. Sec. 59 to 61 of the Indian contract Act deal with the provisions of the right of appropriation of payments.

In right of appropriation, we find how a debtor who has three or four debit account settler by making payments to the credits.

Condition Applying:

a) When making payment to a creditors debtor has right to inform the creditor, that as towards which loan he is making. (Sect 59).

b) When a debtor has not exercised his right, the creditor has the right to appropriate the payment made by debtor towards any loan, according to his discrete (sec. 60).

c) When neither the debtor nor the creditor exercises their right for appropriation, then it is the chronological order in which the debit entries have arisen, the credit entries will go to discharge the debit entries.

Right to charge, interest, commission and brokerage :

A banker grants loan and advances to customers and charges interest on the same banker usually debit the customer's account when the customer fails to pay the interest amount every month. After three months the interest will be added to the principal amount. Interest will be then charged on the new principal amount.

Similarly for collecting cheques, dividends and interest warrants, the banker can commission and brokerage charges

Right to close the account of undesirable customer :

Undesireable customer is one who has been frequently issuing cheques which are bouncing or which are getting dishonoured. Due to this, the reputation of the banker is affected.

In such situation, the banker after giving due notice to the customer, can close the account.

1.7 DUTIES OF A BANKER :

Duty to honour cheque :

It is the duty of the banker to honour cheque of customer which are drawn properly and presented during the working hours of the bank.

However the Bank has the right to dishonour the cheques under the following situations

Date

- Post dated – a date yet to come
- Stale – more than 3 months

Post dated cheques are those which carry a date which is yet to come. If a banker honours a post dated cheque, he will not only lose statutory protection but will be sued by the customer.

In the case of a stale cheque, when the cheque is more than three months old, it is no more a cheque.

Payee

- Not clear
- Wrong person

When the payee is not clear or when the payee is a wrong person, the banker will not pay and has every right to dishonour.

Amount – In words and figures differ. When the amount given in words and stated in figure differs, the banker will dishonour.

Signature – If the signature is not according to the specimen signature or differs from the specimen, the banker should dishonour.

Endorsements – The endorsements appearing on the cheque should be

		proper and if there is any defect in endorsements, the cheque will be dishonoured.
Insufficient funds	–	If there are insufficient funds in the account and the cheque presented is for a higher amount, the bank will dishonour the cheque and mention the reason as "insufficient funds".
Mutilated Cheque	–	Where the cheques are torn and are beyond recognition.
Smudged Cheque	–	Where the writing on cheque is unclear or smudged because of sweat or water, the banker will dishonour such cheques.
Material Alteration	–	When a cheque contains alterations which are made without the knowledge of the drawer or the banker, with an intention to defraud both parties, the cheque will be dishonoured.

If overwriting or cancellation which are not approved by the drawer, with his full signature on the cheque, at the place of overwriting. The cheque will be dishonoured.

Duty to Maintain Secrecy of Customer's Account :

The banker has an obligation towards customer to maintain secrecy about the status of account. He should not reveal the secrecy of customer's account in the normal course of business. However, in the following conditions the secrecy of the customer's account will be disclosed.

i) Express or Implied condition

ii) Under compulsion of law

iii) In the course of banking business

iv) Disclosure in the public interest

v) Bankers among themselves.

i) Express or implied condition :

- When customer has given in writing to the banker to reveal the secrecy of customer, the banker may do so. This is Expressed condition.
- When the customer acts as a guarantor for a principal Debtor, the banker has to reveal the secrecy of the customer's account to the guarantor. It is implied condition

ii) Under Compulsion of Law :

- Under Income Tax Act 1961, when the Income-Tax authorities demand for the details of the customer's account, the banker has to reveal.
- Under Foreign Exchange Regulation Act.

- Under Indian Penal Code, when any police official makes an enquiry.
- Under Gift Tax Act.
- Under RBI Act.
- Enquiries by Government, both State and Central.
- Under Banking Companies Act, the Central Government and Reserve Bank of India can ask the banker about status of any account.
- Under Indian companies Act sec. 235, 237 and 251.
- Under sec. 4 of Banker's Book Evidence Act. A banker can produce for any investigation, the books, documents belonging to the customer.

iii) In the course of Banking Business :

A bank, in order to protect its own interest, may have to reveal the secrecy of the customer's account.

The banker may disclose the state of his customer's account in order to legally protect his own interest. For, example - if the banker has to recover the dues from the customer or the guarantor, disclosure of necessary facts to the guarantor or the solicitor becomes necessary and is justified.

iv) Disclosure in the Public Interest :

When a customer is amassing wealth by cheating the public and increasing the deposit account with the banker it is the duty of the bank to reveal the same to the public. Otherwise the banker will be held liable for abetting the crime.

v) Bankers among themselves can share information :

Between the bankers as per the trade custom, information can be shared in their own business interests. This is as per the custom of the trade.

It is an established banking practice to provide credit information about their customers by one bank to another. The customer gives implied consent to this practice at the time of opening the account.

Duty to render proper account of deposits made and withdrawn by customer

- It is the duty of the banker to render proper account of deposits and withdrawals by the customer by making entries in passbook and statement of account of customers.
- It is the duty of the customer to verify the entries in the pass book then and there and inform the banker about the discrepancies, if any, shown in the pass book.

1.8 Banker Customer Relationship :

Sl. No	Type of Transaction	Bank	Customer
1	Deposit account, CC (with credit balance)	Debtor	Creditor
2	OD, CC, Loan Account (With debit balance)	Creditor	Debtor
3	Collection of cheques	Agent	Principal
4	Sale or Purchase of Securities	Agent	Principal
5	Issuing/ Purchase of Draft by Purchaser	Debtor	Creditor
6	Payee of Drafts at paying Branch	Trustee	Beneficiary
7	Mail Transfers, Telegraphic Transfers	Agent	Principal
8	Complying with standing instruction	Agent	Principal
9	Providing various service to non Account holder	Agent	Principal
10	Cheques deposited pending instructions for disposal thereof	Trustee	Beneficiary
11	Safe custody of Articles	Bailee	Bailor
12	Leasing of Locker	Lessor	Lessee
13	Mortgage of immovable property	Mortgagee	Mortgagor
14	Pledge of Securities /Shares	Pledgee	Pledgor
15	Hypothecation of Securities	Hypothecate	Hypothecator
16	Sale/Purchase of Shares etc	Agent	Principal
17	Maintaining Currency Chest (RBl's Property)	Agent	Principal

1.9 CONCLUSION :

In the various capacities, as studied, we can understand the role played by modern banker in the trade world of today. The banks also offer various types of modern banking like home banking / e – banking (Net – banking, Mobile – banking etc.). Modern Banking Services made a banking life of a common man very easy.

1.10 SUMMARY :

India is having 21 public sector Banks, the latest, “India Post Payments Bank”, established on 1st September 2018 in New Delhi and the Government has 100% stake in it. There are 22 Private Sectors Banks functioning in our country, the latest two (a) Bandhan Bank, established in 2015 at Kolkata, West Bengal. (b) “IDFC First Bank” in 2015 at Mumbai, Maharashtra. 46 Foreign banks are also operating in India, now.

The main relationship between bank and a customer is that of debtor -creditor in the case of deposit account and creditor-debtor in the case of overdraft or loan account. The bank acts trustee in.The general legal relationship of bank and customer is contractual relationship, started from the date of opening an account. When customer deposits money into his bank account, the bank becomes a debtor of the customer. No new contract is created every time there is a new deposit as the account is continuing in nature. The banker is not, in the general case, the custodian of money. The money paid into a bank account becomes the property of the bank and bank has a right to use the money as it likes. The bank is not bound to inform the depositor the manner of utilization of funds deposited by him. Bank does not give any security to the debtor (depositor).

1.10 KEY WORDS :

Smudged Cheque :

Altered cheques; look out for common alterations such as the date, payee or amount.

Multilated cheque :

A cheque that is torn or damaged is called a mutilated cheque.

Payee :

A party on one side of a transaction who receives payment.

Brokerage :

A brokerage provides intermediary services in various areas.

Eg. Investing, obtaining a loan, or purchasing real estate.

Lien right :

A legal claim or legal right which is made against the assets that are held as collaterals for satisfying a debt.

Set – off :

A legal clause that gives a lender the authority to seize a debtor's deposits when they default on a loan.

Bailor – bailee :

The person delivering the goods is called the "bailor". The person to whom they are delivered is called the "bailee'.

Principal :

The money that you originally agreed to pay back.

Beneficiary :

A beneficiary is the person you're sending money to - also known as a recipient.

Trust :

A trust is a legal contract between at least two parties

1.11 SELF ASSESSMENT QUESTIONS :

1. Distinguish between normal debtor – creditor relationship and a banker – customer relationship.
2. Explain the special relationships between a banker – customer.
3. Describe the banker's right of lien.
4. Explain the duties of the banker.

1.12 SUGGESTED BOOKS :

1. Customer relationship management , edited by jagdish N Sheth,AtulParvatiyar and G Shainesh
2. Banking theory and law & practice, S.N. Maheswari & R.R.Paul

D.Swapna

LESSON – 2

BANKER AND CUSTOMER LEGAL RELATIONSHIP

Objectives:

After reading this lesson, one should be able to -

- understand the meaning and definition of banker
- describe the functions of commercial banks
- understand the banker and customer relations

Structure of the Lesson :

2.1 Introduction of Bank

2.2 Definition of Banker

2.3 Customer

2.4 Functions of commercial banks

2.5 Relationship between banker and customer

2.6 Legal relationship between banker and customer

2.7 Summary

2.8 Key words

2.9 Self assessment questions

2.10 Suggested books

2.1 INTRODUCTION OF BANK :

Since the banking activities were started in different periods in different countries, there is no unanimous view regarding the origin of the word 'Bank'. The word 'Bank' is said to have derived from the French word 'Banco' or 'Bancus' or 'Bank' or 'Banque' which means a 'Bench'. In fact the early Jews in Lombardy transacted their banking business by sitting on benches. When their business failed the benches were broken and hence the word 'Bankrupt' come into vogue.

Another common – held view is that the word 'Bank' might be originated from the German word 'Bank' which means a joint stock fund.

2.2 DEFINITION OF BANKER

A person who is doing the banking business is called a banker. But it is not easy to define the term 'Banker' because a banker performs multifarious functions.

First : A banker must be a man of wisdom, he deals with others money but, with his own mental faculties.

Second : A banker is not only acting as a depositor, agent but also as a financial advice.

The bill of exchange Act of 1882 defines the banker "Banker includes a body of persons whether incorporated or not who carry on the business of banking".
According to **section – 3 of the Negotiable instruments act** state that "The term banker includes a person or a corporation or a company acting as a banker".

Definition of Bank :
According section – 5(B) of Banking Regulation Act banking has been defined as "Accepting for the purpose of lending and investment of deposits of money from the public, repayable on demand order or otherwise and with drawable by cheque, draft order or otherwise".

2.3 DEFINITION OF CUSTOMER :

According to Sir John Paget's view "To constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business". According to him a person a customer of a bank have to satisfy the two conditions.

First condition : (Duration theory)

"There must be some recognizable course or habit of dealing between the person and the banker" means that there must be some duration of dealings between the person and the banker. In other words, a single banking transaction will not make a person a customer of a bank. He must maintain his account with the bank for a reasonable duration or period. This condition is commonly known as the duration of dealing or duration theory".

Second condition :

"The transaction or dealing between the person and the bank must be in the nature of regular banking business" mean that the dealings or transaction must be regular banking business and not casual transaction.

The same view was expressed in the case of Mathew's v/s Williams Brown & co. his view regarding the dealing of banking nature has been universally accepted. But, his view about
duration is subjects to several criticisms. It is very difficult to say how many transactions will make a person, a customer or how much time should elapse between two successive transactions to qualify a person as a customer. Therefore, the duration theory exploded, discarded.

2.4 FUNCTIONS OF COMMERCIAL BANKS :

The functions of the commercial banks are now wide and diverse. They have assumed great significance in the role of an agent for social transformation because of their vital role in mobilization of resources as well as deployment for meeting the said objectives.
The functions can be classified into :

1. Primary functions

2. Secondary functions

1) Primary Functions :

a) Accepting of Deposits :

Deposits are an important source of banks funds. They are classified in to three categories :

i. Savings Deposits : these deposits are of small amounts and are accepted by the banks to encourage person of small means to make savings. Deposits can be made at any time but frequent withdrawals are not allowed. The deposits earn interest.

ii. Fixed Deposits : These are deposits made with the bank for fixed period of time and are repayable on the date of maturity. A customer can use a fixed deposit as security for a loan in same bank or another bank.

iii. Current Deposits : These deposits are repayable on demand. The banks undertake an obligation of paying all cheques drawn against these deposits by the customers till they have adequate funds of the customer. The banks usually do not pay interest in respect of such deposits. Usually, banks issue monthly statements showing the transactions in the accounts. Deposits are repayable on demand without prior notice. The customer may issue cheques to third parties or may withdraw from counter or via ATM.

b) Lending of Money :

The major portion of the deposits received by the bank is lent out. Interest earned from lending is the main income of the bank, however, lending money is not without risk, and therefore, a banker must take precautions in this process.

The lending may be in the form of :

i. Loans

ii. Cash Credit

iii. Overdraft

iv. Discounting and Purchasing of the bills.

Thus commercial banks fender unique service by tapping savings from a wide spectrum of people and lending to those who really need and use them for various productive purposes.

2) Secondary Function :

Agency service such as :

a) Collection of drafts, bills, cheques, dividend, etc. on behalf of customers

b) Execution of standing orders of customers

c) Conducting of stock exchange transactions

d) Functioning as an executor, trustee or administrator of an estate of a customer

3) Ancillary or miscellaneous functions :

General utility services such as :

a) Issuing of letters of credit

b) Issuing of travelers cheques

c) Accepting valuables for safe keeping

d) Acting as referee as to the respectability and financial standing of the for customers

e) Providing specialized advisory services to customers

f) Issue of credit cards

g) Providing of information through regular bulletins about general trade and economic conditions

h) Merchant banking e.g. counseling, sponsor of share issue, investment management,
etc.

2.5 RELATIONSHIP BETWEEN BANKER AND CUSTOMER :

Relationship between a banker and a customer may be divided into two types, they are :

I. General relationship.

II. Special relationship.

I. General relationship :

The general relationship between a banker and a customer may be sub-divided into:

1. Primary general relationship.
2. Subsidiary general relationship.

1) Primary general relationship :

The primary general relationship arises from a contract between the two i.e. banker and a customer. So it is a contractual relationship. It is governed by the various terms of agreement between the two parties.

Nature of primary general relationship :

When a banker receives deposits of money from a customer, he is neither a bailee nor a trustee nor an agent, but only a debtor. According to Sir John Paget," the relation of banker and customer is primarily that of debtor and creditor, the respective positions being determined by the existing state of the account".

a) Banker is only a debtor in respect of customer's money :

The banker is just a debtor, and the customer is creditor, when he accepts and has the deposits of the customer. Of course, in case the customer's account is overdraw or the customer has taken loan or any other form of financial accommodation from the banker, the customer becomes the debtor and the banker becomes the creditor.

The debtor and creditor relationship of banker and customer has certain features :

A banker is a debtor, when he holds his customer's deposit. But he is a privileged, Honored or dignified debtor. He is a privileged debtor for the following reasons :

i. Banker's borrowing from a customer is nothing but a debt; it is given a dignified name 'deposit'.

ii. Generally, for borrowing money, a debtor goes to the creditor. But in case of bank deposit, the creditor goes to the debtor for giving the amount.

iii. Normally, a debtor is required to repay the debt of his own but a banker need not repay the deposit to the depositor of his own. He has to repay the deposit only when there is an express demand in writing by the customer.

iv. A banker cannot be asked by the customer to repay the deposit at a place other than the one where the deposit is kept.

v. A banker can be asked to repay the deposit only on a working day and only during working hours.

vi. A banker is not required to give any security to the customer for the deposit accepted.

b) Customer is only general creditor of the banker :

The customer is the creditor of the banker when he has some deposit in the bank. But he cannot be a secured creditor of the banker because he does not get any charge on any asset of the banker.

A banker can be a secured creditor of the customer, when an advance is granted by him to the customer against some tangible securities. That means even when he becomes a creditor, he becomes a privileged creditor.

c) Demand for repayment of deposits is necessary :

For the repayment of the deposit due from the banker to the customer an express demand for repayment is required to be made by the customer.

d) Customer can demand repayment of deposits whenever he wants.

e) Customer's demand for repayment of deposits should be made at proper place.

f) Customer's demand for repayment of deposits should be made on a working day and during business hours.

g) Customer's demand for repayment of deposits should be made in proper form.

2) Subsidiary general relationship between a banker and customer :

When a deposit of money is received and an account is opened by a banker in the name of customer, the primary relationship between the banker and the customer is created, and that relationship is that of a debtor and a creditor but this does not mean that there cannot be any other relationship between the banker and the customer. The banker and the customer can also enter into subsidiary relationships like that of bailee & bailor, trustee & beneficiary, and agent & principal by special agreement or arrangements.

a) Bailee and Bailor :

When a banker accepts valuable and documents from a customer for safe custody, he becomes a bailee and the customer become a bailor.

As a bailee, the banker owes some duties and liabilities to the customer. They are :

i. He is required to safeguard the safe – custody deposits of the customer in his hands with reasonable care.

ii. If he fails to take reasonable care in the preservation of the safe-custody deposits, and the customer suffers a losses a consequence, so banker will be liable to compensate the customer.

iii. He is required to hand over the safe-custody deposit to the depositor whenever he demands them back.

b) Trustee and Beneficiary :

A banker becomes the trustee of his customer, when he is entrusted with some trust for instance, when a customer deposits a certain sum of money with banker with specific instructions to use the same for a specific purpose, the banker becomes the trustee of the customer in respect of that money until that purpose is fulfilled.

When a cheque or a bill of exchange is deposited with a bank for collection, the bank becomes a trustee for the cheque or bill till it is collected. Of course once the cheque is collected and the proceeds are credited to the customer's account the banker becomes the debtor.

When banker is appointed as trustee for the customer's property he becomes a trustee of the customer and he owes some duties.

i. He is required to deal with the trust money or property in accordance with the terms of the trust deed.

ii. He is required to give a detailed account of the trust property to the beneficiary.

iii. He should be banded to hand over the profits earned from the use of the trust property to the beneficiary who is entitled to the benefits of the trust property.

c) Agent and Principal :

When a banker undertakes agency service such as collection of cheque, drafts and bills, collection of interests and dividends on securities payment of premium and subscriptions, purchase and sale of securities, etc., for a customer, he becomes the agent and the customer becomes the principal. As an agent, the banker owes some duties to the customer. They are :

i. He is required to act in accordance with the instructions of the principal i.e. the customer.

ii. He is bound to return to the customer all the incomes which he earns as an agent of the customer.

d) Mortgagee and Morgagor relationship :

The relationship between banker and customer may be mortgagee (pledgee) and mortgagor (pledger) when customer pledge any valuable assets as security to take loan.

e) Guarantor and Guarantee relationship :

At the time of international trade importer needs guarantee to receive goods from the exporter. Here bank gives guarantee to its customer i.e. bank issue “letter of credit” to exporter by stating strength of importer financial position.

II. Special relationship :

Special relationship between a banker and a customer refers to the special obligations and rights of the banker against the customer and vice-versa. The rights and obligations are reciprocal i.e. customers rights are bankers duties and bankers rights are customer duties.

The various special features of relationship between the banker and the customer are :

1) Obligations

a) Banker’s obligation to honour his customer’s cheques :

When a current account is opened by a banker in the name of a customer there is an obligation on the banker to honour the customer’s cheque as long as there are sufficient funds available in the customer’s account for meeting the cheques. The debts are repayable by the banker to the customer on demand as per contract entered into between them.So,whenever the customer demands the repayment of his deposits by issuing cheques, there is a contractual obligation on the banker to honour his customer’s cheques and repay his deposits.

According section-31 of the Indian negotiable instrument act of 1881 provide, “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 to do so, and in default of such payment, must compensate the drawer for any loss or damage caused by such default.”

Banker’s obligation to honour cheques is subject to certain conditions :

i. **Sufficient funds must be available :**

The banker must have sufficient funds of the customer to pay his cheques. If the banker does not have sufficient funds of the customer, he can dishonour the cheque issued by the customer. It should be noted that when the funds of the customer lying in the hands of the banker are not sufficient to pay the cheque in full, the banker need not make a part payment for that cheque to the extent of the balance available. He can just dishonour that cheque.

ii. **Funds must be properly applicable to the payment of the cheque :**

The customer’s funds in hands of the banker must be properly applicable to the payment of the payment of the cheque presented.

iii. **Banker must be duly required to pay the cheque :**

The banker must be duly required to pay the customer’s cheque. That means the bank should pay the cheque only if it is complete and is in order and is presented within a reasonable time after its date of issue.

iv. **There must be no legal bar presenting the payment of the cheque :**

If there is a garnishee order issued by a court attaching the funds of the customer in a particular account, a cheque drawn against that garnished account should not be paid by the banker.

OBLIGATIONS OF A BANKER :

Though the primary relationship between a banker and his customer is that of a debtor and creditor or vice versa, the special features of this relationship, impose the following additional

Obligations on the banker :

Obligations to honour the cheques :

The deposits accepted by a banker are his liabilities repayable on demand or otherwise. The banker is, therefore, under a statutory obligation to honour his customer’s cheques in the usual course. Section 31 of the Negotiable Instruments Act, 1881, lays down that :

"The drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment must compensate the drawer for any loss or damage caused by such default."

Obligation to maintain Secrecy of Account :

The account of the customer in the books of the banker records all of his financial dealings with the latter and the depicts the true state of his financial position. If any of these facts is made known to others, the customer's reputation may suffer and he may incur losses also. The banker is, therefore, under an obligation to take utmost care in keeping secrecy about the accounts of his customers. By keeping secrecy is meant that the account books of the bank will not be thrown open to the public or Government officials and the banker will take all necessary precautions to ensure that the state of affairs of a customer's account is not made known to others by any means. The banker is thus under an obligation not to disclose-deliberately or intentionally-any information regarding his customer's accounts to a third party and also to take all necessary precautions and care to ensure that no such information leaks out of the account books.

The nationalized banks in India are also required to fulfill this obligation. Section 13 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, specially requires them to "observe, except as otherwise required by law, the practices and usages customary amongst bankers and in particular not to divulge any information relating to the affairs of the constituents except in circumstances in which they are, in accordance with law or practices and usages or appropriate for them to divulge such information." Thus, the general rule about the secrecy of customer's accounts may be dispensed with in the following circumstances :

- When the law requires such disclosure to be made; and
- When practices and usages amongst the bankers permit such disclosure.

A banker will be justified in disclosing information about his customer's account on reasonable and proper occasions only as stated below :

(a) Disclosure of Information required by Law :

A banker is under statutory obligation to disclose the information relating to his customer's account when the law specially requires him to do so. The banker would, therefore, be justified in disclosing information to meet statutory requirements :

(i) Under the Income – Tax Act, 1961. According to Section 131, the income tax authorities possess the same powers as are vested in a Court under the Code of Civil Procedure, 1908, for enforcing the attendance of any person including any offer of banking company or any offer thereof, to furnish information in relation to such points or matters, as in the opinion of the income-tax authorities will be useful for or relevant to any proceedings under the Act. The income –tax authorities are thus authorized to call for necessary information from the banker for the purpose of assessment of the bank customers.

Section 285 of the Income- tax Act, 1961, requires the banks to furnish to the Income-tax Officers the names and addresses of all persons to whom they have paid interest exceeding ` 400 mentioning the actual amount of interest paid by them.

(ii) Under the Companies Act, 1956. When the Central Government appoints an Inspector or to investigate the affairs of any joint stock company under Section 235 or 237 of the Companies Act, 1956, it shall be the duty of all officers and other employees and agents (including the bankers) of the company to -

(a) produce all books and papers of, or relating to, the company, which are in their custody or power, pand

(b) otherwise to give the Inspector all assistance in connection with investigation which they are reasonably able to give (Section 240). Thus the banker is under an obligation to disclose all information regarding the company but no of any other customer for the purpose of such investigation (Section 251).

(iii) By order of the Court under the Banker's Books Evidence Act, 1891. When the court orders the banker to disclose information relating to a customer's account, the banker is bound to do so. In order to avoid the inconvenience likely to be caused to the bankers from attending the Courts and producing their account books as evidence, the Banker's Books Evidence Act, 1891, provides that certified copies of the entries in the banker's book are to be treated as sufficient evidence and production of the books in the Courts cannot be forced upon the bankers. According to Section 4 of the Act, " a certified copy of any entry in a banker's book shall in all legal proceedings be received as prima facie evidence of the matters, transitions and accounts therein recorded in every case where, and to the same extent, as the original entry itself is now by law admissible, but not further or otherwise."Thus if a banker is not a party to a suit, certified copy of the entries in his book will be sufficient evidence. The Court is also empowered to allow any party to legal proceedings to inspect or copy from the books of the banker for the purpose of such proceedings.

(iv) Under the Reserve Bank of IndiaAct,1934. The Reserve Bank of India collects credit information from the banking companies and also furnishes consolidated credit information from the banking company. Every banking company is under a statutory obligation under Section 45-B of the Reserve Bank. The Act, however, provides that the Credit information supplied by the Reserve Bank to the banking companies shall be kept confidential. After the enactment of the Reserve Bank of India(Amendment) Act, 1974, the banks are granted statutory protection to exchange freely credit information mutually among themselves.

(v) Under the Banking Regulation Act, 1949. Under Section 26, every banking company is requires to submit a return annually of all such accounts in India which have not been operated upon for 10years. Banks are required to give particulars of the deposits standing to the credit of each such account.

(vi) Under the Gift Tax Act, 1958. Section 36 of the Gifts Tax Act, 1958, confers on the Gift Tax authorities powers similar to those conferred on Income- Tax authorities under Section 131 of the Income Tax Act [discussed above (i).]

(vii) Disclosure to Police. Under Section 94 (3) of the Criminal Procedure Code, the banker is not exempted from producing the account books before the police. The police officers conducting an investigation may also inspect the banker's books for the purpose of such investigations (section 5. Banker'sBooks Evidence Act).

(viii) Under the Foreign Exchange Management Act, 1999, under section10. Banking companies dealing in foreign exchange business are designated as 'authorized persons' in foreign exchange. Section36, 37 and 38 of this Act empowers the officer of the Directorate of Enforcement and the Reserve Bank to investigate any contravention under the Act.

(ix) Under the Industrial Development Bank of India Act, 1964. After the insertion of sub-section1A in Section 29 of this Act in 1975, the Industrial Development Bank of India is authorized to collect from or furnish to the Central Government, the State Bank, any subsidiary bank, nationalized bank or other scheduled bank, State Co-operative Bank, State Financial Corporation credit information or other information as it may consider useful for the purpose of efficient discharge of its functions. The term 'credit information' shall have the same meaning as under the Reserve Bank of India Act,1934.

(b) Disclosure permitted by the Banker's Practices and Usages :

The practices and usages customary amongst bankers permit the disclosure of certain information under the following circumstances :

(i) With Express or Implied Consent of the Customer. The banker will be will be justified in disclosing any information relating to his customer's account with the latter's consent. In fact the implied term of the contract between the banker and his customer is that the former enters into a qualified obligation with the latter to abstain from disclosing information as to his affairs without his consent (Tourniers vs. National Provincial and Union Bank of India). The consent of the customer may be expressed or implied. Express consent exists in case the customer directs the banker in writing to intimate the balance in his account or any other information to his agent, employee or consultant. The banker would be justified in furnishing to such person only the required information and no more. It is to be noted that the banker must be very careful in disclosing the required information to the customer or his authorized representative. For example, if an oral enquiry is made at the counter, the bank employee should not speak in louder voice so as to be heard by other customers. Similarly, the pass-book must be sent to the customer through the messenger in a closed cover. A banker generally does not disclose such information to the customer over the telephone unless he can recognize the voice of his customer; otherwise he bears the risk inherent in such disclosure.

In certain circumstances, the implied consent of the customer permits the banker to disclose necessary information. For example, if the banker sanctions a loan to a customer on the guarantee of a third person and the latter asks the banker certain questions relating to the customer's account. The banker is authorized to do so because by furnishing the name of the

guarantor, the customer is presumed to have given his implied consent for such disclosure. The banker should give the relevant information correctly and in good faith. Similarly, if the customer furnishes the name of the banker to a third party for the purpose of a trade reference, not only an express consent of the customer exists for the discloser of relevant information but the banker is directed to do so, the non – compliance of which will adversely affect the reputation of the customer. Implied consent should not be taken for granted in all cases even where the customer and the enquirer happen to be very closely related. For example, the banker should not disclose the state of a lady's account to her husband without the express consent of the customer.

(ii) The banker may disclose the state of his customer's account in order to legally protect his own interest. For example, if the banker has to recover the dues from the customer or the guarantor, disclosure of necessary facts to the guarantor or the solicitor becomes necessary and is quite justified.

(iii) Banker's Reference. Banker follows the practice of making necessary enquires about the customers,their sureties or the acceptors of the bills from other bankers. This is an established practice amongst the bankers and is justified on the ground that an implied consent of the customer is presumed to exist. By custom and practice necessary information or opinion about the customer is furnished by the banker confidentially. However, the banker should be very careful in replying to such enquiries.

Precautions to be taken by the banker : The banker should observe the following precautions while giving replies about the status and financial standing of a customer:

(i) The banker should disclose his opinion based on the exact position of the customer as is evident from his account. He should not take into account any rumour about his customer's credit worthiness.He is also not expected to make further enquiries in order to furnish the information. The basis of his opinion should be the record of the customer's dealings with banker.

(ii) He should give a general statement of the customer's account or his financial position without disclosing the actual figures. In expressing his general opinion he should be very cautious-he should neither speak too low about the customer nor too high. In the former case he injures the reputation of the customer ; in the latter, he might mislead the enquirer. In case unsatisfactory opinion is to be given, the banker should give his opinion in general terms so that it does not amount to a derogatory remark. It should give a caution to the enquirer who should derive his own conclusions by inference and make further enquiries, if he feels the necessity.

(iii) He should furnish the required information honestly without bias or prejudice and should not misrepresent a fact deliberately. In such cases he incurs liability not only to his own customer but also to the enquirer.

(c) Duty to the public to disclose : Banker may justifiably disclose any information relating to his customer's account when it is his duty to the public to disclose such information. In practice this qualification has remained vague and placed the banks in

difficult situations. The Banking Commission, therefore, recommended a statutory provision clarifying the circumstances when banks should disclose in public interest information specific cases cited below :

(i) when a bank asked for information by a government official concerning the commission of a crime and the bank has reasonable cause to believe that a crime has been committed and that the information in the bank's possession may lead to the apprehension of the culprit,

(ii) where the bank considers that the customer's is involved in activities prejudicial to the interests of the country.

(iii) where the bank's books reveal that the customer is contravening the provisions of any law, and

(iv) where sizable funds are received from foreign countries by a constituent.

2.6 THE GENERAL LEGAL RELATIONSHIP BETWEEN BANK AND ITS CUSTOMER :

There are numerous kinds of relationship between the bank and the customer. The relationship between a banker and a customer depends on the type of transaction; products or services offered by bank to its customers. The legal relationship between a bank and its customer differs in several important respects from the relationships between most other service providers. In order to answer the question, the essay will begin by describing and analysing the legal relationship between a bank and its customer. After that, it will goes on to compare that between other service providers and their customer.

The general legal relationship between bank and its customer :

The general legal relationship of bank and customer is contractual relationship, started from the date of opening an account. When customer deposits money into his bank account, the bank becomes a debtor of the customer. No new contract is created every time there is a new deposit as the account is continuing in nature. The banker is not, in the general case, the custodian of money. The money paid into a bank account becomes the property of the bank and bank has a right to use the money as it likes. The bank is not bound to inform the depositor the manner of utilization of funds deposited by him. Bank does not give any security to the debtor (depositor). The bank has borrowed money but does not pay money on its own, as banker is to repay the money upon payment being demanded. Thus, bank's position is quite different from normal debtors. On the other hand, when the bank lends money to his customer, the relationship between the bank and customer is reversed. Then the bank takes the position as a creditor of the customer and the customer becomes a debtor of the bank. Borrower executes documents and offer security to the bank before utilizing the credit facility. Therefore, the general relationship between bank and its customer is that of a debtor and a creditor.

On the other hand, the relationship between the customer and the banker can be that of principal and agent. Agent can be defined as a person employed to do any act for another

or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called “the principal”. In acting on instructions to make periodical payment or transfer money from customer’s account to others, to collect cheques or bills, the bank acted as agent of its customer. Prima facie every agent for reward is bound to exercise reasonable skill and care in carrying out the instructions of his principal. The standard of care expected is one of an ordinary and prudent banker and not that of a detective.

Building society vs. Bank :

Building societies, like bank, are deposit – taking institution. Generally speaking, the relationship between building society and its customer is that of a debtor and a creditor. This is the similarity between bank and building society. But specifically building societies are differs from banks as building societies are owned by their customers, this simply means that those who have a savings account, or mortgage, are members and have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. Each building society has a board of directors who run the society and who are responsible for setting its strategy. In contrast, banks are normally companies listed on the stock market and are therefore owned by, and run for, their shareholders.

Investment Company vs. Bank :

The relationship between the investment company and its customer is fiduciary in character. As such, an investment adviser stands in a special relationship of trust and confidence with its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser’s fiduciary duty depend on the scope of the advisory relationship and generally include the duties to make reasonable basis investment advice, to seek best execution for client securities transactions where the adviser directs such transactions and to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest.

As a result, the legal rights and duties of an investment manager also differ from that of bank. An investment company will owe to his client both a common law duty of care in tort and fiduciary duties. Generally, a bank does not have a duty to advise its customer on the suitability of a transaction; nor does it has a duty to protect the customer from imprudent transactions. The relationship between a bank and its customer is not fiduciary in character. As noted by Lord Justice Dunn, “Banks are not charitable institution”. Moreover, bank is not under an implied duty to bring to the attention of the customer a new type of banking facility which may reasonably be capable of being applied to or being utilised by customer in the known circumstances of its business and banking requirements. Nonetheless, it must be borne in mind that the limits of a banker’s business cannot be defined as a matter of law. If a banker undertakes to advice, he must exercise reasonable care and skill in giving the advice. Furthermore, under the Hedley Byrne principle, a bank which assumes responsibility towards a customer for advising on investments or on the commercial merits of a proposed transaction owes a duty of care even if the advice is gratuitous. Prior to the case of

Hedley Byrne v Heller, the court in Woods v Martins Bank Ltd held that it is possible for a bank to owe fiduciary duties to its customer. This is largely because the bank agreed to a request from a customer to manage his financial affairs. Indeed, the bank manager knew the customer relied on his advice and there were conflicts of interest because the advice was to invest in a company that was also in debt to the bank.
However, it has been argued that Salmon J was forced to rely on the fiduciary principle to impose liability on the bank since there was no remedy in tort for a negligent misstatement at that time. Thus, it is very unlike the court will resort to the device of a fiduciary relationship if it happens again.

Insurance Company vs. Bank :

Similarly, insurance company are different from bank because there is a "special relationship" between the insurance company and the policyholder. The special relationship consists of a combination of elements such as the fiduciary duties insurance companies owe to its policyholders and the duty of good faith and fair dealing inherent in every insurance policy between an insurance company and its policyholder. Among an insurer's fiduciary responsibilities is the duty of disclosure.

Insurance companies' duty of disclosure requires that they provide certain information to their prospective and current policyholders, such as the scope and limitations of the insurance coverage being agreed to, the consequences of various events, the responsibilities of the insurance company and all other terms of the insurance policy. When an insurance company failed to meet its duty of disclosure, it is considered an act of bad faith that gives actionable cause to the policyholder to seek relief for any resulting losses. In contrast, the bank is only required to supply the customer with relevant information such as APR calculation, copy of agreement, balance and etc.

Trust Company vs. Bank :

A trust company is a corporation organized to perform the fiduciary of trusts and agencies. The "trust" name refers to the ability of the institution's trust department to act as a trustee, who administers financial assets on behalf of customer (settler). The assets are typically held in the form of a trust, a legal instrument that spells out the beneficiaries and what the money can be spent for. A trustee's power to dispose of the trust property or to arrange the property is subject to the wishes of the customer (settler). In contrast, the receipt of money on deposit account constitutes the banker a debtor to the depositor but not a trustee of the customer. Therefore, the customer has no right to inquire into, or question the use of, the money by the banker. A trust involves the administration of assets on behalf of an individual whether he is living or dead. Therefore, the trust arrangement will still be going on after the death of the customer (settler). However, the relationship between a bank and a customer ceases on the death, insolvency, lunacy of the customer.

However, the position is otherwise if the banker assumes the office of trustee. Moreover, a banker is affected by the existence of a trust where an account is opened by a customer acting in the capacity of trustee15, or where the banker is on notice that a payment

into or out of the account is in breach of trust16, or where money is paid to a banker for a particular purpose in circumstances such as to impress the payment with a trust17.

Duty of Confidentiality :

One of the similarities between bank and other service providers is that the legal relationship between them and their customers will give rise to a duty of confidentiality. They are disallowed to disclose the information about their customer to third party even when the person is no longer their customer. However, the decision of the Court of Appeal in Tournier v. National Provincial and Union Bank of England enunciated four exceptional cases in which disclosure is justified:(1) Where disclosure is under compulsion of law (2) Where there is a duty to the public to make the information known (3) Where the interests of the bank require disclosure (4) Where the disclosure is made by the express or implied consent of the customer. Other than that, banker and all other service providers are under duty to disclose when it involves in cases of money laundering. Currently, there are two statutes of primary importance in governing the duty of confidentiality: Data Protection Act 1998 and the Human Right Act 1998. The Data Protection Act 1998 gives effect to European Council Directive 95/46 on the protection of personal information. On the other hand, Article 8 of the Human Rights Act 1998 enshrines the right to respect for private and family life.

Undue Influence :

The relationship between banker and customer will not generally give rise to a presumption of undue influence. In the ordinary course of banking commerce, a banker is allowed to explain the nature of a proposed transaction without laying himself open to a charge of undue influence. However, comparing with other service providers, the relationship between investment advisors and investor, insurance company and policy holder, trustee and beneficiary, all of them will give rise to a presumption of undue influence. This is because there is certain degree of trust and confidence between them and their customers. It has been regarded as a norm.

Conclusion :

The legal relationship between the banker and his customer has varied over the centuries. Unquestionably, the core banking activities of deposit-taking and lending are not fiduciary in character. Thus, the legal relationship between a bank and its customers can be distinguished from that between other service providers and their customers is that of fiduciary relationship. Nevertheless, due to the complexities of business and banking, the relationship between bankers and customers goes beyond the primary relationship of creditor and debtor. Some other activities that modern multifunctional banks frequently engage in are more obviously fiduciary in character, e.g. where the bank manages its customer’s investment portfolio or provides its customer with corporate finance services. Therefore, it is possible that a banker act as an agent or trustee of the customer like any other service providers.

2.7 SUMMARY :

The latest legal formalities and practices followed by a modern banker and the other

guidelines necessary for opening various bank accounts have been enumerated. The details of KYC norms to be followed for opening bank accounts are given. We have also studied the circumstances for closure of a bank account. Relationship between a banker and a customer may be divided into two types, they are general and special relationship. There are numerous kinds of relationship between the bank and the customer. The relationship between a banker and a customer depends on the type of transaction; products or services offered by bank to its customers. The legal relationship between a bank and its customer differs in several important respects from the relationships between most other service providers.

The legal relationship between the banker and his customer has varied over the centuries. Unquestionably, the core banking activities of deposit-taking and lending are not fiduciary in character. Thus, the legal relationship between a bank and its customers can be distinguished from that between other service providers and their customers is that of fiduciary relationship. Nevertheless, due to the complexities of business and banking, the relationship between bankers and customers goes beyond the primary relationship of creditor and debtor. Some other activities that modern multifunctional banks frequently engage in are more obviously fiduciary in character, e.g. where the bank manages its customer's investment portfolio or provides its customer with corporate finance services. Therefore, it is possible that a banker act as an agent or trustee of the customer like any other service providers.

2.8 KEY WORDS :

Cash Credit :

Cash Credit (CC) is a source of short term finance for businesses and companies.

Overdraft :

Overdraft is a credit facility that allows you to withdraw funds from your current or savings account even if your bank balance is zero.

Bank :

A bank is a financial institution licensed to receive deposits and make loans.

Customer :

A person who has an account with a bank or has a relationship with the banker even though he has no account with the bank.

Deposits :

A deposit is money you put into your bank account.

Agency services :

Agency banking, also known as branchless banking, allows banks to bring their services directly to users rather than requiring them to visit a physical branch.

Ancillary :

Banking services other than lending and deposit are known as ancillary services.

Letters of Credit :

A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount.

2.9 SELF ASSESSMENT QUESTIONS :

1. Define the word banker and customer
2. What are the functions of commercial banks
3. Write about the general relationship between banker and customer
4. What are the special relationship with banker and customer

2.10 SUGGESTED BOOKS :

1. Banker and customer relationship, Satyanaryana P V V by discovery publishing house Pvt. Ltd.
2. Customer relationship management , edited by Jagdish N Sheth, AtulParvatiyar and G Shainesh.

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LESSON – 3
OPENING & CLOSING OF BANK ACCOUNTS

Objectives :

- To understand the procedure for opening of various bank accounts
- To know about the formalities to be complied for opening a bank account
- To know the circumstances under which a bank account is to be closed

Structure of the Lesson :

3.1 Opening of a bank account
  - 3.1.1 Opening Savings Bank Account
  - 3.1.2 Opening Current Account
  - 3.1.3 Opening Fixed deposit account and Recurring deposit account

3.2 Steps in opening accounts
  - 3.2.1 Obtaining letter of Introduction
  - 3.2.2 Application form
  - 3.2.3 Specimen Signature
  - 3.2.4 First Transaction
  - 3.2.5 Issue of Cheque, Pay-in-slip, and Passbook
  - 3.2.6 Pay-in-slip Book
  - 3.2.7 Donatio mortis causa
  - 3.2.8 Printed cheque forms

3.3 Customer identification and key norms
  - 3.3.1 Meaning
  - 3.3.2 Legal Compliance
  - 3.3.3 Applicability
  - 3.3.4 Customer Identification
  - 3.3.5 KYC documents for normal customers

3.4 Closing of Bank Accounts

3.5 Conclusion

3.6 Summary

3.7 Key Words

3.8 Self Assessment Questions

3.9 Suggested Books

3.1 OPENING OF A BANK ACCOUNT :

3.1.1 Opening Savings Bank Account :

Normally, a banker will not open an account in favour of a stranger. Any person who wishes to open a savings account has to be introduced by another savings account holder of the same branch. Even a minor is allowed to open a saving account.

3.1.2 Opening Current Account :

In the case of current account, it cannot be opened by any person unless he is introduced by another current account holder of the branch. The current account holder has to give a letter of introduction in favour of the person intending to open the current account.

Current account can also be opened when the employee of the bank gives a letter of introduction about the person intending to open the current account. A third type of letter of introduction can be given by a well reputed person known to the banker.

The contents of letter of introduction must spell out the conduct and character of the person intending to open the current account. It is more of a fidelity guarantee vouchsafing the character of the person, willing to open the current account. The banker requires such a letter as the current account holder is not only providing with overdraft and cash credit facility but also acceptance of third party cheques through endorsement.

At present the bank insists not only the introduction but also the photographs in duplicate of persons intending to open an account; one photograph is affixed in the pass book and the other in the ledger.

3.1.3 Opening Fixed Deposit Account and Recurring Deposit :

For opening a fixed deposit account, the banker does not impose any condition. But he normally accepts fixed deposits from known persons and the fixed deposit account is opened only by deposit cash or in case of cheques only after realization of cheques. The same rule applies for recurring deposit also.

3.2 STEPS IN OPENING ACCOUNTS :

Following are the steps involved in the opening of an account for customer, by a banker :

3.2.1 Obtaining Letter of Introduction :

The first and the foremost step in opening an account for a new customer is to obtain a letter of introduction from the person who wants to open an account. A letter obtained by abanker from a prospective customer before a banker can open an account in the name of the

prospective customer is known as 'letter of introduction'. The purpose of obtaining this type of a letter enables the banker to ascertain the genuineness of applicant. The letter serves as a letter of guarantee of conduct and genuineness of the applicant obtaining a letter of introduction is an important duty of a modern banker. The information obtained so helps the banker in confidently providing various services of banking and financial services. The information is also need to obtain protection from the provisions of the various legislations that are in force from time to time as part of carrying out the banking business.

Benefits / purposes :

Obtaining a proper letter of introduction is beneficial for the banker to know more about the new customer in the following manner :

- Protecting against issuing cheque books to unscrupulous persons.
- Facilitating the claiming of overdraft inadvertently granted by the banker.
- Protecting against undischarged insolvent.
- Helping to provide correct financial information about the customer.
- Obtaining statutory protection.

3.2.2 Application Form :

After obtaining a letter of introduction, the banker supplies an application form according to the type of account, which the customer wants to open. The application form contains the rules and regulations of the bank with the terms and conditions of deposit. The application form is to be filled in and handed over to the banker. The applicant furnishes all details about himself including the name, nomination, address, etc,.

3.2.3 Specimen Signature :

After the application form duly filled in, the banker obtains the specimen signature of the new customer in a separate card called 'specimen signature' card. Every customer is expected to have read the rules of business of the bank to confirm in writing his willingness to comply with and bound by them before his account is opened. He is required to supply his bankers with one or more specimens of his signature and the bank usually enters these in a signature card maintained for the purpose. The cards are filed and arranged in an alphabetical order. Each customer's name must be written in bold characters above his account in the ledger. His address and occupation are also noted.

3.2.4 First Transaction :

After obtaining the specimen signature of the new customer, the banker open the ne account by obtaining cash from the new customer. This marks the first transaction between the

new customer and the banker. The relationship between the banker and customer begins after this transaction.

3.2.5 Issue of Cheque, Pay-in –slip, and Passbook :

The banker issues pay – in – slips, cheque book, and passbook immediately after successfully completing the first transaction with the customer. The cheque book supplied to the customer usually contains ten or twenty blank forms. These leaves are used for making payments. A cheque book contains a requisition slip which helps to get a new cheque book. Pay –in – slip or credit voucher are forms used to pay coins, notes, bills, and cheques to the credit of customer's account. Each slip should be signed by the customer or the person who has prepared it on his behalf. For correct accounting, name, account number, date, and the amount of the customer should be clearly mentioned. Customer will receive a duplicate slip or counterfoil with a signature and the rubber stamp of the banker. It is an acknowledgement to the customer that cash, etc,. have been duly received. The initials of the cashier in counterfoil donot in any way mean that the cheques, etc., are in order.

3.2.6 Pay – In – Slip Book :

The pay – in – slip book is a book that contains printed slips with perforated counterfoils to be filled in by the depositor or his agent at the time of depositing cash, cheques, drafts,etc., to the credit of his account. Usually every bank prescribes and supplies free of cost separate pay-inslips for depositing cash and cheques and drafts. The contents of pay-in–slips include the information regarding the date of deposit, name and account number of the customer, amount to be deposited, etc.

3.2.7 'Donatio Mortis Causa' :

'Donatio mortis causa' means a gift made in contemplation of death. The gift is said to be made by a person who owns any movable property and who is very ill and believes that he is going to die. This is a peculiar gift as it has a condition that it will come into operation if only the donor actually dies of the illness. But if he recovers from the illness, the gift is to e returned.

3.2.8 Printed Cheque Forms - Merits :

A cheque drawn on any paper is legally valid. In England, banks honor cheques even they are not drawn on forms supplied by them. However, when the customer draws a cheque on ordinary slip of paper, the banker must be careful to see that it is an unconditional order. Otherwise the banker would lose the statutory protection. But it is to be noted that using plain papers to write cheques will prove risky for the paying banker. Hence, bankers always insists on using printed cheque forms to enable customers to derive the following advantages :

1. Easy and convenience of writing a cheque, only the relevant columns need to be filled in.
2. Avoidance of forgery and hence safety to banker and customer too.

3. Easy detection of fraud in a printed form is possible.
4. Ensure that the signature is drawn only according to the requirements of law.
5. Facility of verifying the customer's name by referring to chequebook issue record.
6. Easy countermanding of cheques by the customer; it is enough if the customer instructs to countermand the cheque number to the banker in case of fraud.
7. Counterfoils kept by the customer can be used as a record of payment made.
8. Popularity of name of the company or the individual where the names are printed on the cheque.

3.3 CUSTOMER IDENTIFICATION AND KYC NORMS :

3.3.1 Meaning :

The term KYC for ' Know Your Customer'. KYC is used for identifying a customer of banking and a financial service company such as a Mutual Fund, Pension Fund, etc. KYC essentisally involves making reasonable efforts to determine true identity and beneficial ownership of accounts, source of funds, the nature of customer's business etc.

The objective of KYC is to help the banks and financial institutions to manage their risks prudently. KYC is made available by the RBI by way of guidelines designed to prevent banks from being used, intentionally or unintentionally by criminal elements for money laundering. There are two important components of KYC, viz., Identity and Address. While identity remains the same, the address may change and hence the banks are required to periodically update their records.

3.3.2 Legal Compliance :

KYC norms have legal backing of the RBI. RBI has issued guidelines to banks under Section Regulation Act, 1949 and Rule 7 of Prevention of Money – Laundering (Maintenance of Records of the Nature and Value of Transactions, Time for Furnishing Information and Verification and Maintenance of records of the Identity of the Clients of Banking Companies, Financial Institutions and Intermediaries) Rules, 2005. Any contravention thereof non-compliance will attract penalties under Banking Regulation Act.

3.3.3 Applicability :

KYC norms are applicable to a bank customer. For this purpose, a customer includes the following :

- A person or entity that maintains an account and / or has a business relationship with the bank.
- One on whose behalf the account is maintained i.e., the beneficial owner.

- Beneficiaries of transactions conducted by professional intermediaries such as Stock Brokers, Charted Accountants, Solicitors etc as permitted under the law.
- Any person or entity connected with a financial transaction which can pose significant reputational of other risks to the bank, say, wire transfer or issue of a high value demand draft as a single transactions.

In certain cases such as ‘ no frill accounts’, which are meant providing basic banking facilities to poor and promote financial inclusion, KYC norms are rather relaxed by banks.

3.3.4 Customer Identification :

Customer identification involves identifying the customer and verifying the identity by using reliable, independent source documents, data or information. Banks have been advised by the RBI to lay down Customer Identification Procedure to be carried out different stages i.e., while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customers, KYC details about a customer are required to be updated periodically by the banker. Banks create a customer profile with details on social/ financial status, nature of business activity, information about his clients’ business and their location, the purpose and reason for opening the account, the expected origin of the funds to be used within the relationship and details of occupation/employment, sources of wealth or income, expected monthly withdrawals etc. In the event of the transactions in the account are bring consistent with the customer profile already created, bank may ask for is any additional details/ documents as required. The ultimate objectives is to ensure that the account is not being used for any Money Laundering / Terrorist/ Criminal activities.

3.3.5 KYC Documents for Normal Customers :

There are two aspects of Customer Identification – One is establishing identity and the other is establishing present residential address. For establishing identity, the bank requires any authentic document carrying photo of the customer such as driving license/ passport/pan card/ voter’ card etc. Though these documents carry the residential address of the customer, it may not be the present address. Therefore, in order to establish the present address of the customer , in addition to passport/driving license/voter’s card / pan card; the bank may ask for utility bills such as Telephone/Electricity bill etc.

A Banker would ask for the following list of documents to establish the proof of identity and residence of a customer.

For Individuals :

The Banker will ask for copies of any the documents such as Aadhar card, Passport, Pan Card, Voter’s Identity Card, Driving License, Identity Card and a letter from a recognized public authority or public servant verifying the identity and residence of the customer to the satisfaction

of the bank. This would help the bank to establish the genuineness of the legal name or any other used by customer. To verify the documents such as Telephone bills, bank account statement, letter from any recognized public authority, electricity bill, ration card and letter from employer (Subject to satisfaction of the bank).

For Companies:

In the case of companies, the banker will ask for documents such as Certificate of Incorporation and the Memorandum of Association and the Articles of Association to verify the name of the company. Similarly, banks will look into the resolution of the Board of Directors to open an account and identification of those who have authority to operate the account to determine the principal place of business.

3.4 CLOSING OF BANK ACCOUNTS :

Similar to the opening of account, banker has to adopt certain procedures while closing of account of a customer. At the time of closing an account, the banker should ask the customer to surrender the unused cheque along with the passbook.

When a customer expresses his willingness to close the account in writing, the banker should settle his account. Before doing so, the banker has to arrive at the closing balance which maybe to the credit or debit of the customer. When the balance is to the credit of the customer, the banker to pay the amount either in person or send the same by a cheque to the address of customer.

In case of undesirable customer, banker will give notice to the customer for closing the account. If the customer evades the request of the banker, a date will be fixed by the banker to close the account. This will be informed to the customer. On that particular day, the bank will close the account of the undesirable customer and send the credit balance to the address of the customer.

A bank will chose the account of the customer under the following conditions

(1) Death of customer

(2) Insolvency of the customer

(3) When customer becomes insane

(4) Garnishee order

(5) With drawl of power attorney

(6) When the partnership firm is dissolved

(7) In case of company, on winding up

(8) When the customer assigns his entire credit balance

(9) In the case of associations and institutions, on the passing of resolution as per the Bye-laws.

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 should be paid to the executor, or administrator of the will. In the absence of a will, the legal heirs have to obtain a Succession Certificate. In that case, he should be satisfied through discreet enquiries that the customer died in state and that the legal heirs are not required to obtain a 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 affidavit from an independent person, indicating their heir- ship or submit an heir – ship certificates.

Insolvency of Customer :

When a customer is adjusted insolvent by the court, an assignee will appointed by the court. The account of the customer in the bank will not be operated by the official assignee appointed by the court. Thus, the account of the customer stands closed and the customer cannot operate the same.

When the customer becomes insane :

When the customer is of unsound mind, the account cannot be operated. As soon as the banker comes to know that the customer is of unsound mind, a doctor will be asked to judge the nature of unsound mind. If it is of permanent nature, the bank will have to close the account of the customer. But if the unsound mind is of a temporary nature, the account will be suspended till such time the customer becomes normal. It is on the basis of medical report, the banker will take a decision.

Garnishee Order :

On the receipt of order from the court, the banker has to close the account of the customer. Such an order is called **Garnishee Order.** This order is of two parts. First, the court will ask the banker about the status of the account which is called Order Nisi. After receiving the explanation from the bank when court sends an absolute order, it is called Order Absolute. Thereupon, the account will be closed. The court orders the closure of the account when creditors of the customer convince the court that in spite of sufficient funds at his disposal, the customer is unwilling to settle their claims.

Withdrawal of Power of Attorney :

When the customer gives permission to another person to operate his account during the absence of the customer, such an account is called Power of attorney account. When the customer withdraws such a power, the agent who was allowed to operate can no longer operate the account.

Dissolution of Firm :

When a partnership firm has an account in a bank, it is operated as long as the firm remains in operation. A firm gets dissolved due to the death, insolvency, insane, etc., of any partner or all the partners. The partners may also agree to dissolve the firm. In all the above cases, the account of the firm stands closed.

Winding up of Company :

A company's account will be operated as long as it is in operation. Once the company's winding up process commences, the account will operated by liquidator. The company's account stands closed.

Assignment of credit balance :

When a customer informs the banker to assign his entire credit balance to third party, the account of the customer gets closed.

Closing of Account of Associations and Institution :

The accounts of association, institutions with the bank are operated as per their bye-laws. When they pass a resolution to close the account with the bank, it will be closed as per the provisions provided in their bylaws.

3.5 CONCLUSION :

The latest legal formalities and practices followed by a modern banker and the other guidelines necessary for opening various bank accounts have been enumerated. The details of KYC norms to be followed for opening bank accounts are given. We have also studied the circumstances for closure of a bank account.

3.6 SUMMARY :

Opening and closing of bank account statements provide a comprehensive overview of transactions, balances, and activities in a bank, financial, or other account. They include details such as deposits, withdrawals, interest earned, fees charged, and the current balance. It also shows the rules and regulations of opening and closing of bank accounts. The latest legal formalities and practices followed by a modern banker and the other guidelines necessary for opening various bank accounts have been enumerated. The details of KYC

norms to be followed for opening bank accounts are given. We have also studied the circumstances for closure of a bank account.

3.7 KEY WORDS :

Fixed deposit account :

A fixed deposit is a type of deposit in which a sum of money is locked for a fixed period of time.

Recurring Deposit :

A Recurring Deposit (RD) is a term deposit that allows to make regular deposits & earn returns on the investment.

Specimen Signature :

A copy of your name written by yourself that a bank or other organization keeps so that they can be sure that your name on a cheque or other document was also written by you.

Pay In Slip :

A pay in slip is a form that banks use to deposit money into a customer's account.

Donatio Mortis Causa :

A gift made in contemplation of death, conditional on death, the donor having parted with dominion over the subject-matter of the gift.

KYC (Know Your Customer) Norms :

Designed to protect financial institutions against fraud, corruption, money laundering and terrorist financing.

Insolvency :

Insolvency refers to situations where a debtor cannot pay the debts they owe.

Attorney :

A person who has the legal right to act for someone else.

Winding up :

Closing the operations of a business, selling off assets, paying off creditors, and distributing any remaining assets to the owners.

Dissolution :

Dissolution is any of several legal events that terminate a legal entity or agreement.

3.8 SELF ASSESSMENT QUESTION :

1. What is letter of introduction?
2. What do you mean by specimen signature?
3. Explain 'Donatio Mortis Causa'.
4. What is KYC?
5. What is garnishee order?
6. Give the procedure for opening a bank account.
7. Bring out the significance of KYC (Know Your Customer) norms to a banker.
8. What are the merits of printed cheques forms?
9. Explain the circumstances under which a bank account is to closed.

3.9 SUGGESTED BOOKS :

1. Banking Theory and Law & Practice, S.N. Maheswari & R.R. Paul
2. Banking law and Practice, Kalkundrikar, Kembhavi,Nataraj - Himalaya Publishing House.

D. Swapna

Lesson – 4

TYPES OF CUSTOMERS

Objectives :

After reading this lesson, you should be able to

- Understand meaning, essential characteristics and types of bank deposit customers;
- understand the concepts of individuals, joint Hindu family and partnership firms;
- to know about the limited liability companies, clubs etc.

Structure of the Lesson :

4.1 Introduction

4.2 Types of Bank deposit customers

4.3 Various types of Customers

- 4.3 1 Individuals
- 4.3 2 Joint Hindu Family (JHF)
- 4.3 3 Partnership firms
- 4.3 4 Joint Stock Companies (Limited Liability Companies)
- 4.3 5 Clubs, Societies and Associations
- 4.3 6 Trust Account
- **4.3.2** Co – operative Societies
- **4.3.3** Local Authorities

4.4 Summary

4.5 Key words

4.6 Self assessment questions

4.7 Suggested books

4.1 INTRODUCTION:

A bank account can be opened in one of two ways: online or offline. One can either seek a new bank account in a nearby branch or begin the process online by going to the bank's website. Selecting a bank depending on your preferences, submitting appropriate paperwork, and financing your account are all steps in the process of opening an account. You can start using your account after the formalities are completed, saving time and money. However, before beginning the process, a person must first decide which type of bank account they wish to open, such as savings, current, or fixed deposit account.

Furthermore, the individual must guarantee that he has all of the necessary supporting documents to open a bank account. Although some paperwork may differ from one bank to the next, there are some standard criteria for opening a bank account.

- PAN card, Voter ID, Passport, Driving license, or Aadhaar card as the documents of proof of age and identity.
- Banks and financial institutions require recent passport-sized pictures.
- A driver's license, a utility bill in the applicant's name, a voter ID card, a passport, and other documents as residential proof.

4.2 IMPORTANT TYPES OF BANK DEPOSIT CUSTOMERS :

Types of Bank deposit customers Banks open accounts for various types of customers like individuals, partnership firm, Trusts, companies, etc. While opening the accounts, the banker has to keep in mind the various legal aspects involved in opening and conducting those accounts, as also the practices followed in conducting those accounts. Normally, the banks have to deal with following types of deposit customers.

- Individuals
- Joint Hindu Families
- Partnership Firms
- Limited Liability Companies
- Clubs and Associations
- Trusts

1. Individuals :

The depositor should be properly introduced to the bank and KYC norms are to be observed. Introduction is necessary in terms of banking practice and also for the purpose of

protection under section 131 of the Negotiable Instruments Act. Usually, banks accept introductions from the existing customers, employee of the bank, a locally well-known person or another bank.

A joint account may be opened by two or more persons and the account opening form etc., should be signed by all the joint account holders. When a joint account is opened in the name of two persons, the account operations may done by

- Either or survivor
- Both jointly
- Both jointly or by the survivor
- Former or survivor

When the Joint account is in the names of more than two person, then the following operations are made :

- all of them jointly or by survivors
- any one of them or by more than one of them jointly

Non-resident individuals (NRIS)

Non – Resident Indian means, a person, being a citizen of India or a person of Indian origin residing outside India. A person is considered Indian Origin when he or his parents or any of his grandparents were Indian National. If at any time held an Indian passport, (nationals of Bangladesh and Pakistan are not deemed to be of Indian origin), a spouse (who is not a Bangladeshi or Pakistan national), of a person of Indian origin shall also be deemed to be of Indian origin. Non-resident falls generally into the following two categories:

- A person who stay abroad for the purpose of employment or to carry on business activities or vocation or for any other purpose for an indefinite period of stay outside India and
- Indian National working abroad for a specific period.

Facilities for maintaining bank accounts are available in India to Indian National or origin, living abroad. The exchange control procedures relating to these facilities have been simplified. The details of various deposit schemes available to NRI's are as follows :

Various Types of NRI Accounts :

- Ordinary Non-resident Rupee Accounts (NRO Accounts);
- Non-Resident (External) Rupee Accounts (NRE Accounts);
- Non-resident (Non-Repatriable) Rupee Deposits (NRNR Accounts); and
- Foreign Currency (Non-Resident) Accounts (Banks) Scheme (FCNR (B) Accounts).

While NRO and NRE accounts can be kept in the form of current, savings bank, recurring deposit or term deposit accounts, deposits under NRNR and FCNR (B) schemes can be kept only in the form of term deposits for periods ranging from six months to three years.

2. Joint Hindu Family (JHF) :

Joint Hindu Family (JHF) (also known as Hindu Undivided family) is a legal entity and is unique for Hindus. It has perpetual succession like companies; but it does not require any registration. The head of JHF is the Karta and members of the family are called co-parceners. The JHF business is managed by Karta.

3. Partnership firms :

A partnership is not a legal entity independent of partners. It is an association of persons. Registration of a partnership is not compulsory under Partnership Act. However, many banks insist on registration of a partnership. In any case, ie stamped partnership deed or Partnership letter should be taken when an account is opened for a partnership. The partnership deed will contain names of the partners, objective of the partnership, and other operational details, which should be taken note of by the bank in its dealings.

4. Joint stock companies (Limited Liability Companies) :

A company is registered under companies Act has a legal status independent of that of the share-holders. A company is an artificial person which has perpetual existence with limited liability and common seal. Memorandum and Articles of Association, Certificate of Incorporation, Resolution passed by the Board to open account, name and designations of persons who will operate the account with details of restriction placed on them are the essentials documents required to open an account.

5. Clubs, Societies and Associations :

The clubs, societies, association etc., may be unregistered or registered. Account may be opened only if persons of high standing and reliability are in the managing committee or governing body. Copy of certificate of registration and Copy of bye-law, certified to be the latest, by the Secretary/President are required to be obtained and also a certified copy of the resolution of the Managing Committee/Governing body to open the bank account and giving details of office bearers etc., to operate the account.

6. Trust Account :

Trusts are created by the settler by executing a Trust Deed. A trust account can be opened only after obtaining and scrutinizing the trust deed. The Trust account has to be operated by all the trustees jointly unless provided otherwise in the trust deed. A trustee cannot delegate the powers to other Trustees except as provided for in the Trust Deed. A cheque favoring the Trust shall not be credited to the personal account of the Trustee.

4.3 VARIOUS TYPES OF CUSTOMERS:

4.3.1 Individuals :

Accounts of individuals form a major chunk of the deposit accounts in the personal segment of most banks.
Individuals who are major and of sound mind can open a bank account.

(a) Minors :

In case of minor, a banker would open a joint account with the natural guardian. However to encourage the habit of savings, banks open minor accounts in the name of a minor and allows single operations by the minor himself/ herself. Such accounts are opened subject to certain conditions like,

(i) the minor should be of some minimum age say 12 or 13 years or above

(ii) should be literate

(iii) No overdraft is allowed in such accounts

(iv) Two minors cannot open a joint account.

(v) The father is the natural guardian for opening a minor account, but RBI has authorized mother also to sign as a guardian (except in case of Muslim minors)

(b) Joint Account Holders :

A joint account is an account by two or more persons. At the time of opening the account all the persons should sign the account opening documents. Operating instructions may vary, depending upon the total number of account holders. In case of two persons it may be

(i) jointly by both account holders
(ii) either or survivor
(iii) former or survivor In case no specific instructions is given, then the operations will be by all the account holders jointly.

The instructions for operations in the account would come to an end in cases of insanity, insolvency, death of any of the joint holders and operations in the account will be stopped.

(c) Illiterate Persons :

Illiterate persons who cannot sign are allowed to open only a savings account (without cheque facility) or fixed deposit account. They are generally not permitted to open a current account.

The following additional requirements need to be met while opening accounts for such persons :

– The depositor’s thumb impression (in lieu of signature) is obtained on the account opening

form in the presence of preferably two persons who are known to the bank and who have to certify that they know the depositor.

– The depositor's photograph is affixed to the ledger account and also to the savings passbook for identification.

Withdrawals can be made from the account when the passbook is furnished, the thumb impression is verified and a proper identification of the account holder is obtained

4.3.2 Hindu Undivided Family (HUF) :

HUF is a unique entity recognized under the Hindu customary law as comprising of a 'Karta' (senior-most male member of the joint family), his sons and grandsons or even great grandsons in a lineal descending order, who are 'coparceners' (who have an undivided share in the estate of the HUF). The right to manage the HUF and its business vests only in the Karta and he acts on behalf of all the coparceners such that his actions are binding on each of them to the extent of their shares in the HUF property. The Karta and other coparceners may possess self-acquired properties other than the HUF property but these cannot be clubbed together for the HUF dues.

HUF business is quite distinct from partnership business which is governed by Indian Partnership Act, 1932. In partnership, all partners are individually and collectively liable to outsiders for the dues of the partnership and all their individual assets, apart from the assets of the partnership, would be liable for attachment for partnership dues. Contrarily, in HUF business, the individual properties of the coparceners are spared from attachment for HUF dues.

The following special requirements are to be fulfilled by the banks for opening and conducting HUF accounts :

– The account is opened in the name of the Karta or in the name of the HUF business.

– A declaration signed by Karta and all coparceners, affirms the composition of the HUF, its Karta and names and relationship of all the coparceners, including minor sons and their date of birth.

– The account is operated only by the Karta or the authorized coparceners.

– In determining the security of the family property for purposes of borrowing, the self-acquired properties of the coparceners are excluded.

– On the death of a coparcener, his share may be handed over to his wife, daughters and other female relatives as per the Hindu Succession Act, 1956.

The Hindu Succession Act, 1956 has been amended in 2005. The Amendment Act confers equal rights to daughters in the Mitakshara Coparcenary property. With this amendment the female coparcener can also act as Karta of the HUF. When any HUF property

is to be mortgaged to the Bank as a security of loan, all the major coparceners (including female coparceners) will have to execute the documents

4.3.3 Partnership Firms :

The concept of 'Firm' indicates either a sole proprietary firm or a partner- ship firm.Asole proprietary firm is wholly owned by a single person, whereas a partnership firm has two or more partners. The sole-proprietary firm's account can be opened in the owner's name or in the firm's name. A partnership is defined under section 4 of the Indian Partnership Act, 1932, as the relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all. It can be created by an oral as well as written agreement among the partners. The Partner- ship Act does not provide for the compulsory registration of a firm. While an unregistered firm cannot sue others for any cause relating to the firm's business, it can be sued by the outsiders irrespective of its registration. In view of the features of a partnership firm, bankers have to ensure that the following requirements are complied with while opening its account :

– The account is opened in the name of the firm and the account opening form is signed by all the partners of the firm.

– Partnership deed executed by all the partners (whether registered or not) is recorded in the bank's books, with suitable notes on ledger heading, along with relevant clauses that affect the operation of the account.

– Partnership letter signed by all the partners is obtained to ensure their several and joint liabilities. The letter governs the operation of the account and is to be adhered to accordingly.

The following precautions should be taken in the conduct of a partnership account :

– The account has to be signed 'for and on behalf of the firm' by all the authorized partners and not in an individual name.

– A cheque payable to the firm cannot be endorsed by a partner in his name and credited to his personal account.

– In case the firm is to furnish a guarantee to the bank, all the partners have to sign the document.

– If a partner (who has furnished his individual property as a security for the loan granted to the firm) dies, no further borrowings would be permitted in the account until an alternative for the deceased partner is arranged for, as the rule in Clayton's case operates.

4.3.4 Joint Stock Companies :

A company is a legal entity, distinct from its shareholders or managers, as it can sue and be sued in its own name. It is a perpetual entity until dissolved. Its operations are governed by the provisions of the Companies Act, 1956.

A company can be of three types :

– Private Limited company : Having 2 to 51 shareholders.

– Public company : Having 7 or more shareholders.

– Government company : Having at least 51per cent shareholdings of Government (Central or State).

The following requirements are to be met while opening an account in the name of a company:

– The account opening form meant for company accounts should be filled and specimen signatures of the authorized directors of the company should be obtained.

– Certified up-to-date copies of the Memorandum and Articles of Association should be obtained. The powers of the directors need to be perused and recorded to guard against 'ultra vires' acts of the company and of the directors in future.

– Certificate of Incorporation (in original) should be perused and its copy retained on record.

– In the case of Public company, certificate of commencement of business should be obtained and a copy of the same should be recorded. A list of directors duly signed by the Chairman should also be obtained.

– Certified copy of the resolution of the Board of Directors of the company regarding the opening, execution of the documents and conduct of the account should be obtained and recorded.

4.3.5 Trusts :

A trust is a relationship where a person (trustee) holds property for the benefit of another person (beneficiary) or some object in such a way that the real benefit of the property accrues to the beneficiary or serves the object of the trust. A trust is generally created by a trust deed and all concerned matters are governed by the Indian Trusts Act, 1882.

The trust deed is carefully examined and its relevant provisions, noted. A banker should exercise extreme care while conducting the trust accounts, to avoid committing breach of trust :

– A trustee cannot delegate his powers to other trustees, nor can all trustees by common consent delegate their powers to outsiders.

– The funds in the name of the trust cannot be used for crediting in the trustee's account, nor for liquidating the debts standing in the name of the trustee.

– The trustee cannot raise loan without the permission of the court, unless permitted by the trust deed.

4.3.6 Clubs :

Account of a proprietary club can be opened like an individual account. However, clubs that are collectively owned by several members and are not registered under Societies RegistrationAct, 1860, or under any other Act,are treated like an unregistered firm.

While opening and conducting the account of such clubs, the following requirements are to be met :

– Certified copy of the rules of the club is to be submitted.

– Resolution of the managing committee or general body, appointing the bank as their banker and specifying the mode of operation of the account has to be submitted,

– The person operating the club account should not credit the cheques drawn favouring the club, to his personal account.

4.3.7 Local Authorities :

Municipal Corporation, Panchayat Boards are local authorities created by specific Acts of the state legislature. Their constitution, functions, powers, etc. are governed by those Acts. Bankers should ensure that accounts of such bodies are opened and conducted strictly as per the provisions of the relevant Act and regulations framed there under. The precautions applicable for company or trust accounts are also applicable in the case of these accounts, in order to guard against ultra vires acts by the officers of the local authority operating the account.

4.3.8 Co – operative Societies :

Co – operative societies are required to open accounts only with these banks which are recognized for this purpose (under the Co-operative Society Act). The following documents should be obtained while opening their account:

– Certificate of registration of the society under the Co-operative Society Act.

– Certified copy of the bye-laws of the society.

– Resolution of the managing committee of the society prescribing the conditions for the conduct of the account.

– List of the members of the managing committee with the copy of the resolution electing them as the committee members.

4.4 SUMMARY :

A Bank Account can be opened in one of two ways that are online and offline and it has some rules and regulations and procedures to create a bank account. There are different types of customers (like individuals, joint hindu family, partnership firms, joint stock companies, clubs, societies and associations etc,,) to create bank account . Each and every customer has some rules/procedures to create an account.

4.5 KEY WORDS:

Resolution :

The act of solving or ending a problem or difficulty

Legislature :

A legislature is an assembly with the authority to make laws for a political entity such as a country, nation or city.

Memorandum :

A document recording the terms of a contract or other legal details.

Perpetual :

Perpetuity means forever.

Firm :

A business that employs lawyers to represent clients or argue in court.

Coparceners:

A type of property ownership where multiple people inherit the same property, and each person owns an undivided, transferable interest in the property.

Committee :

A body of persons delegated to consider, investigate, take action on, or report on some matter.

Association :

An unincorporated organization of people banded together for a specific purpose.

4.6 SELF ASSESSMENT QUESTIONS:

1. What are the important types of deposit customers
2. Types of customers
3. Write about the individuals
4. Explain about partnership firms
5. Joint stock companies

4.8 SUGGESTED BOOKS:

1. Banking theory and law & practice, S.N. maheswari & R. R. Paul
2. Banking law and practice, Kalkundrikar, Kembhavi, Nataraj – Himalaya Publishing House.

D. Swapna

LESSON – 5
NEGOTIABLE INSTRUMENTS ACT, 1881

Objectives :

After reading this lesson, one should be able to

- Understand meaning, essential characteristics and types of negotiable instruments;
- Describe the meaning and marketing of cheques, crossing of cheques and cancellation of crossing of a cheque;
- Explain capacity and liability parties to a negotiable instruments; and Understand various provisions of negotiable instrument Act, 1881 regarding negotiation, assignment, endorsement, acceptance, etc. of negotiable instruments.

Structure of the Lesson :

5.1 Introduction

5.2 Meaning of Negotiable Instruments

5.3 Characteristics of a negotiable instrument

5.4 Presumptions as to negotiable instrument

5.5 Types of negotiable Instrument

5.5.1 Promissory notes

5.5.2 Bill of exchange

5.5.3 Cheques

5.5.4 Hundis

5.6 Parties to negotiable instruments

5.6.1 Parties to Bill of Exchange

5.6.2 Parties to a Promissory Note

5.6.3 Parties to a Cheque

5.7 Summary

5.8 Keywords

5.9 Self Assessment Questions

5.10 Suggested Books

5.1 INTRODUCTION :

The Negotiable Instruments Act was enacted, in India, in 1881. Prior to its enactment, the provision of the English Negotiable Instrument Act were applicable in India, and the present Act is also based on the English Act with certain modifications. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934. Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorised by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to be payable or demand or after a certain time. Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are :

1. A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.
2. A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.
3. But a cheque {though a bill of exchange} payable to bearer or demand can be drawn on a person's account with a banker.

5.2 MEANING OF NEGOTIABLE INSTRUMENTS :

According to Section 13 (a) of the Act, "Negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or " bearer" appear on the instrument or not."

In the words of Justice, Willis, "A negotiable instrument is one, the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any defects of the title in the person from whom he took it".

Thus, the term, negotiable instrument means a written document which creates a right in favour of some person and which is freely transferable. Although the Act mentions only these three instruments (such as a promissory note, a bill of exchange and cheque), it does not exclude the possibility of adding any other instrument which satisfies the following two conditions of negotiability :

1. the instrument should be freely transferable (by delivery or by endorsement. and delivery) by the custom of the trade; and
2. the person who obtains it in good faith and for value should get it free from all defects, and be entitled to recover the money of the instrument in his own name.

As such, documents like share warrants payable to bearer, debentures payable to bearer and dividend warrants are negotiable instruments. But the money orders and postal orders, deposit receipts, share certificates, bill of lading, dock warrant, etc. are not negotiable instruments. Although they are transferable by delivery and endorsements, yet they are not able to give better title to the bonafide transferee for value than what the transferor has.

5.3 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT :

A negotiable instrument has the following characteristics :

1. **Property :** The possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument does not merely give possession of the instrument but right to property also. The property in a negotiable instrument can be transferred without any formality. In the case of bearer instrument, the property passes by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transfer of property.

2. **Title :** The transferee of a negotiable instrument is known as ‘holder in due course.’ A bona fide transferee for value is not affected by any defect of title on the part of the transferor or of any of the previous holders of the instrument.

3. **Rights :** The transferee of the negotiable instrument can sue in his own name, in case of dishonour. A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

4. **Presumptions :** Certain presumptions apply to all negotiable instruments e.g., a presumption that consideration has been paid under it. It is not necessary to write in a promissory note the words ‘for value received’ or similar expressions because the payment of consideration is presumed. The words are usually included to create additional evidence of consideration.

5. **Prompt payment :** A negotiable instrument enables the holder to expect prompt payment because a dishonour means the ruin of the credit of all persons who are parties to the instrument.

5.4 PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENT :

Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes in regard to negotiable instruments. In other words these presumptions need not be proved as they are presumed to exist in every negotiable instrument. Until the contrary is proved the following presumptions shall be made in case of all negotiable instruments :

1. **Consideration :** It shall be presumed that every negotiable instrument was made drawn, accepted or endorsed for consideration. It is presumed that, consideration is present in every negotiable instrument until the contrary is

presumed. The presumption of consideration, however may be rebutted by proof that the instrument had been obtained from, its lawful owner by means of fraud or undue influence.

2. **Date :** Where a negotiable instrument is dated, the presumption is that it has been made or drawn on such date, unless the contrary is proved.

3. **Time of acceptance :** Unless the contrary is proved, every accepted bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity. This presumption only applies when the acceptance is not dated; if the acceptance bears a date, it will prima facie be taken as evidence of the date on which it was made.

4. **Time of transfer :** Unless the contrary is presumed it shall be presumed that every transfer of a negotiable instrument was made before its maturity.

5. **Order of endorsement :** Until the contrary is proved it shall be presumed that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

6. **Stamp :** Unless the contrary is proved, it shall be presumed that a lost promissory note, bill of exchange or cheque was duly stamped.

7. **Holder in due course :** Until the contrary is proved, it shall be presumed that the holder of a negotiable instrument is the holder in due course. Every holder of a negotiable instrument is presumed to have paid consideration for it and to have taken it in good faith. But if the instrument was obtained from its lawful owner by means of an offence or fraud, the holder has to prove that he is a holder in due course.

8. **Proof of Protest :** Section 119 lays down that in a suit upon an instrument which has been dishonoured, the court shall on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

5.5 TYPES OF NEGOTIABLE INSTRUMENT :

Section 13 of the Negotiable Instruments Act states that a negotiable instrument is a promissory note, bill of exchange or a cheque payable either to order or to bearer. Negotiable instruments recognised by statute are :

(i) Promissory notes

(ii) Bills of exchange

(iii) Cheques.

Negotiable instruments recognised by usage or custom are :

a) Hundis
b) Share warrants
c) Dividend warrants

d) Bankers draft
e) Circular notes
f) Bearer debentures
g) Debentures of Bombay Port Trust
h) Railway receipts
i) Delivery orders.

This list of negotiable instrument is not a closed chapter. With the growth of commerce, new kinds of securities may claim recognition as negotiable instruments. The courts in India usually follow the practice of English courts in according the character of negotiability to other instruments.

5.5.1 Promissory notes :

Section 4 of the Act defines, "A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments."

Essential elements :

An instrument to be a promissory note must possess the following elements :

1. **It must be in writing :** A mere verbal promise to pay is not a promissory note. The method of writing (either in ink or pencil or printing, etc.) is unimportant, but it must be in any form that cannot be altered easily.

2. **It must certainly an express promise or clear understanding to pay :** There must be an express undertaking to pay. A mere acknowledgment is not enough. The following are not promissory notes as there is no promise to pay.

   If A writes :

   (a) "Mr. B, I.O.U. (I owe you) Rs. 500"

   (b) "I am liable to pay you Rs. 500".

   (c) "I have taken from you Rs. 100, whenever you ask for it have to pay" .

   The following will be taken as promissory notes because there is an express promise to pay :

   If A writes :

   (a) "I promise to pay B or order Rs. 500".

   (b) "I acknowledge myself to be indebted to B in Rs. 1000 to be paid on demand, for the value received".

(3) **Promise to pay must be unconditional :** A conditional undertaking destroys the negotiable character of an otherwise negotiable instrument. Therefore, the promise to pay must not depend upon the happening of some outside contingency or event. It must be payable absolutely.

(4) **It should be signed by the maker :** The person who promise to pay must sign the instrument even though it might have been written by the promisor himself. There are no restrictions regarding the form or place of signatures in the instrument. It may be in any part of the instrument. It may be in pencil or ink, a thumb mark or initials. The pronote can be signed by the authorised agent of the maker, but the agent must expressly state as to on whose behalf he is signing, otherwise he himself may be held liable as a maker. The only legal requirement is that it should indicate with certainty the identity of the person and his intention to be bound by the terms of the agreement.

(5) **The maker must be certain :** The note self must show clearly who is the person agreeing to undertake the liability to pay the amount. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. In case two or more persons promise to pay, they may bind themselves jointly or jointly and severally, but their liability cannot be in the alternative.

(6) **The payee must be certain :** The instrument must point out with certainty the person to whom the promise has been made. The payee may be ascertained by name or by designation. A note payable to the maker himself is not pronate unless it is indorsed by him. In case, there is a mistake in the name of the payee or his designation; the note is valid, if the payee can be ascertained by evidence. Even where the name of a dead person is entered as payee in ignorance of his death, his legal representative can enforce payment.

(7) **The promise should be to pay money and money only :** Money means legal tender money and not old and rare coins.
A promise to deliver paddy either in the alternative or in addition to money does not constitute a promissory note.

(8) **The amount should be certain :** One of the important characteristics of a promissory note is certainty—not only regarding the person to whom or by whom payment is to be made but also regarding the amount.

However, paragraph 3 of Section 5 provides that the sum does not become indefinite merely because

(a) there is a promise to pay amount with interest at a specified rate.

(b) the amount is to be paid at an indicated rate of exchange.

(c) the amount is payable by installments with a condition that the whole balance shall fall due for payment on a default being committed in the payment of anyone installment.

(9) **Other formalities :** The other formalities regarding number, place, date, consideration etc. though usually found given in the promissory notes but are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case, omission of date does not invalidate the instrument and the date of execution can be independently ascertained and proved.

On demand (or six month after date) I promise to pay Peter or order the sum of rupees one thousand with interest at 8 per cent per annum until payment.

5.5.2 Bill of exchange :

Section 5 of the Act defines, "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".

A bill of exchange, therefore, is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. There are usually three parties to a bill of exchange drawer, acceptor or drawee and payee. Drawer himself may be the payee.

Essential conditions of a bill of exchange

(1) It must be in writing.

(2) It must be signed by the drawer.

(3) The drawer, drawee and payee must be certain.

(4) The sum payable must also be certain.

(5) It should be properly stamped.

(6) It must contain an express order to pay money and money alone.

For example, in the following cases, there is no order to pay, but only a request to pay. Therefore, none can be considered as a bill of exchange :

(a) "I shall be highly obliged if you make it convenient to pay Rs. 1000 to Suresh".

(b) "Mr. Ramesh, please let the bearer have one thousand rupees, and place it to my account and oblige"

However, there is an order to pay, though it is politely made, in the following examples:

(a) "Please pay Rs. 500 to the order of 'A'.

(b) 'Mr. A will oblige Mr. C, by paying to the order of' P".

(c) The order must be unconditional.

Distinction between Bill of Exchange and Promissory Note :

1. **Number of parties :** In a promissory note there are only two parties – the maker (debtor) and the payee (creditor). In a bill of exchange, there are three parties; drawer, drawee and payee; although any two out of the three may be filled by one and the same person,

2. **Payment to the maker :** A promissory note cannot be made payable the maker himself, while in a bill of exchange to the drawer and payee or drawee and payee may be same person.

3. **Unconditional promise :** A promissory note contains an unconditional promise by the maker to pay to the payee or his order, whereas in a bill of exchange, there is an unconditional order to the drawee to pay according to the direction of the drawer.

4. **Prior acceptance :** A note is presented for payment without any prior acceptance by the maker. A bill of exchange is payable after sight must be accepted by the drawee or someone else on his behalf, before it can be presented for payment.

5. **Primary or absolute liability :** The liability of the maker of a promissory note is primary and absolute, but the liability of the drawer of a bill of exchange is secondary and conditional.

6. **Relation :** The maker of the promissory note stands in immediate relation with the payee, while the maker or drawer of an accepted bill stands in immediate relations with the acceptor and not the payee.

7. **Protest for dishonor :** Foreign bill of exchange must be protested for dishonour when such protest is required to be made by the law of the country where they are drawn, but no such protest is needed in the case of a promissory note.

8. **Notice of dishonor :** When a bill is dishonoured, due notice of dishonour is to be given by the holder to the drawer and the intermediate indorsers, but no such notice need be given in the case of a note.

Classification of Bills :

Bills can be classified as :

(1) Inland and foreign bills.

(2) Time and demand bills.

(3) Trade and accommodation bills.

(1) Inland and Foreign Bills :

Inland bill : A bill is, named as an inland bill if :

(a) it is drawn in India on a person residing in India, whether payable in or outside India, or

(b) it is drawn in India on a person residing outside India but payable in India.

The following are the Inland bills

(i) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is payable in Bombay. The bill is an inland bill.

(ii) A bill is drawn by a Delhi merchant on a person in London, but is made payable in India. This is an inland bill.

(iii) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is accepted for payment in Japan. The bill is an inland bill.

Foreign Bill : A bill which is not an inland bill is a foreign bill. The following are the foreign bills :

1. A bill drawn outside India and made payable in India.
2. A bill drawn outside India on any person residing outside India.
3. A bill drawn in India on a person residing outside India and made payable outside India.
4. A bill drawn outside India on a person residing in India.
5. A bill drawn outside India and made payable outside India.

Bills in sets (Secs. 132 and 133) : The foreign bills are generally drawn in sets of three, and each sets is termed as a 'via'.

As soon as anyone of the set is paid, the others becomes inoperative. These bills are drawn in different parts. They are drawn in order to avoid their loss or miscarriage during transit. Each part is dispatched separately. To avoid delay, all the parts are sent on the same day; by different mode of conveyance.

Rules : Sections 132 and 133 provide for the following rules -

(i) A bill of exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue payable only so long as the others remain unpaid. All parts make one bill and the entire bill is extinguished, i.e. when payment is made on one part- the other parts will become inoperative (Section 132).

(ii) The drawer should sign and deliver all the parts but the acceptance is to be conveyed only on one of the parts. In case a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill (Sec. 132).

(iii) As between holders in due course of the different parts of the same bill, he who first acquired title to anyone part is entitled to the other parts and is also entitled to claim the money represented by bill (Sec. 133).

(2) Time and Demand Bill :

Time bill : A bill payable after a fixed time is termed as a time bill. In other words, bill payable "after date" is a time bill.

Demand bill : A bill payable at sight or on demand is termed as a demand bill.

(3) Trade and Accommodation Bill :

Trade bill : A bill drawn and accepted for a genuine trade transaction is termed as a "trade bill".

Accommodation bill : A bill drawn and accepted not for a genuine trade transaction but only to provide financial help to some party is termed as an "accommodation bill".

Example : A, is need of money for three months. He induces his friend B to accept a bill of exchange drawn on him for Rs. 1,000 for three months. The bill is drawn and accepted. The bill is an "accommodation bill". A may get the bill discounted from his bankers immediately, paying a small sum as discount. Thus, he can use the funds for three months and then just before maturity he may remit the money to B, who will meet the bill on maturity.

In the above example A is the "accommodated party" while B is the "accommodating party". It is to be noted that an recommendation bill may be for accommodation of both the drawer arid acceptor. In such a case, they share the proceeds of the discounted bill.
Rules regarding accommodation bills are :

(i) In case the patty accommodated continues to hold the bill till maturity, the accommodating party shall not be liable to him for payment of, the bill since the contract between them is not based on any consideration (Section 43).

(ii) But the accommodating party shall be liable to any subsequent holder for value who may be knowing the exact position that the bill is an accommodation bill and that the full consideration has not been received by the acceptor. The accommodating party can, in turn, claim compensation from the accommodated party for the amount it has been asked to pay the holder for value.

(iii) An accommodation bill may be negotiated after maturity. The holder or such a bill after maturity is in the same position as a holder before maturity, provided he takes it in good faith and for value (Sec. 59)

In form and all other respects an accommodation bill is quite similar to an ordinary bill of exchange. There is nothing on the face of the accommodation bill to distinguish it from an ordinary trade bill.

5.5.3 Cheques :

Section 6 of the Act defines "A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand".

A cheque is bill of exchange with two more qualifications, namely, (i) it is always drawn on a specified banker, and (ii) it is always payable on demand. Consequently, all cheque are bill of exchange, but all bills are not cheque. A cheque must satisfy all the requirements of a bill of exchange; that is, it must be signed by the drawer, and must contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a certain person or to the bearer of the cheque. It does not require acceptance.

Distinction between Bills of Exchange and Cheque :

1. A bill of exchange is usually drawn on some person or firm, while a cheque is always drawn on a bank.
2. It is essential that a bill of exchange must be accepted before its payment can be claimed A cheque does not require any such acceptance.
3. A cheque can only be drawn payable on demand, a bill may be also drawn payable on demand, or on the expiry of a certain period after date or sight.
4. A grace of three days is allowed in the case of time bills while no grace is given in the case of a cheque.
5. The drawer of the bill is discharged from his liability, if it is not presented for payment, but the drawer of a cheque is discharged only if he suffers any damage by delay in presenting the cheque for payment.
6. Notice of dishonour of a bill is necessary, but no such notice is necessary in the case of cheque.
7. A cheque may be crossed, but not needed in the case of bill.
8. A bill of exchange must be properly stamped, while a cheque does not require any stamp.
9. A cheque drawn to bearer payable on demand shall be valid but a bill payable on demand can never be drawn to bearer.
10. Unlike cheques, the payment of a bill cannot be countermanded by the drawer.

5.5.4 Hundis :

A "Hundi" is a negotiable instrument written in an oriental language. The term hundi includes all indigenous negotiable instrument whether they be in the form of notes or bills.
The word 'hundi' is said to be derived from the Sanskrit word 'hundi', which means "to collect". They are quite popular among the Indian merchants from very old days. They are used to finance trade and commerce and provide a fascile and sound medium of currency and credit.

Hundis are governed by the custom and usage of the locality in which they are intended to be used and not by the provision of the Negotiable Instruments Act. In case there is no customary rule known as to a certain point, the court may apply the provisions of the Negotiable Instruments Act. It is also open to the parties to expressly exclude the applicability of any custom relating to hundis by agreement (lndur Chandra vs. Lachhmi Bibi, 7 B.I.R. 682).

5.6 PARTIES TO NEGOTIABLE INSTRUMENTS :

5.6.1 Parties to Bill of Exchange :

1. **Drawer:** The maker of a bill of exchange is called the 'drawer'.
2. **Drawee:** The person directed to pay the money by the drawer is called the 'drawee',
3. **Acceptor**: After a drawee of a bill has signed his assent upon the bill, or if there are more parts than one, upon one of such pares and delivered the same, or given notice of such signing to the holder or to some person on his behalf, he is called the ' acceptor'.
4. **Payee:** The person named in the instrument, to whom or to whose order the money is directed to be paid by the instrument is called the 'payee'. He is the real beneficiary under the instrument. Where he signs his name and makes the instrument payable to some other person, that other person does not become the payee.
5. **Indorser:** When the holder transfers or indorses the instrument to anyone else, the holder becomes the 'indorser'.
6. **Indorsee:** The person to whom the bill is indorsed is called an 'indorsee'.
7. **Holder:** A person who is legally entitled to the possession of the negotiable instrument in his own name and to receive the amount thereof, is called a 'holder'. He is either the original payee, or the indorsee. In case the bill is payable to the bearer, the person in possession of the negotiable instrument is called the 'holder'.
8. **Drawee in case of need:** When in the bill or in any endorsement, the name of any person is given, in addition to the drawee, to be resorted to in case of need, such a person is called 'drawee in case of need'.

   In such a case it is obligatory on the part of the holder to present the bill to such a drawee in case the original drawee refuses to accept the bill. The bill is taken to be dishonoured by non-acceptance or for nonpayment, only when such a drawee refuses to accept or pay the bill.
9. **Acceptor for honour:** In case the original drawee refuses to accept the bill or to furnish better security when demanded by the notary, any person who is not

liable on the bill, may accept it with the consent of the holder, for the honour of any party liable on the bill. Such an acceptor is called 'acceptor for honour'.

5.6.2 Parties to a Promissory Note :

1. **Maker.** He is the person who promises to pay the amount stated in the note. He is the debtor.
2. **Payee.** He is the person to whom the amount is payable i.e. the creditor.
3. **Holder.** He is the payee or the person to whom the note might have been indorsed.
4. The indorser and indorsee (the same as in the case of a bill).

5.6.3 Parties to a Cheque :

1. **Drawer.** He is the person who draws the cheque, i.e., the depositor of money in the bank.
2. **Drawee**. It is the drawer's banker on whom the cheque has been drawn.
3. **Payee.** He is the person who is entitled to receive the payment of the cheque.
4. The holder, indorser and indorsee (the same as in the case of a bill or note).

5.7 SUMMARY :

Negotiable instrument is a document which creates a right in favour of some person and which is freely transferable. Although the act mentions only these three instruments (such as a promissory note, a bill of exchange and cheque). It includes certain characteristics. Negotiable instruments act states that it is a promissory note, bill of exchange or a cheque payable either to order or to bearer. It also includes the parties to a Bill of exchange, parties to a promissory note and parties to a cheque.

5.8 KEY WORDS :

Negotiable Instruments :

Is a signed document that promises a payment to a specified person or assignee.

Property :

Anything that is owned by a person or entity.

Promt Payment :

Prompt payment means payment of a debt due and owing by a corporation before interest accrues thereon pursuant to a statement adopted in accordance with this section.

Order of Endorsement :

The written directions a judge gives you and your partner that says what you

must do or not do.

Promissory Note :

A legal, financial tool declared by a party, promising another party to pay the debt on a particular day.

Bill of Exchange :

A bill of exchange is a written order binding one party to pay a fixed sum of money to another party on demand or at some point in the future.

Dishonour :

Dishonor is the refusal to honor and pay an instrument

Inland Bill :

A bill of exchange that is both drawn and made payable in the same country.

Trade Bill :

A bill of exchange (a document ordering someone to pay a particular amount at a particular time) that is used to pay for goods

Cheques :

A bill of exchange in which one party orders the bank to transfer the money to the bank account of another party.

Hundies :

A financial instrument or a negotiable bill of exchange.

5.9 SELF ASSESSMENT QUESTIONS :

1. Write about the meaning and definition of negotiable instruments
2. Characteristics of negotiable instruments
3. Types of negotiable instruments
4. Parties to negotiable instruments

5.10 SUGGESTED BOOKS :

1. Bhole, L.M., Financial Institutions and Markets, 4th ed., Tata McGraw Hills, New Delhi, 2004.

1. Bank Financial Management, Indian Institute of Banking and Finance, Taxman's Publications, July 2004.

2. Negotiable Instruments Act,1881.

V. Sakunthala

LESSON – 6

PAYING BANKER

Objectives :

- To know the meaning of paying banker and how he pays
- To understand the payment in due course and conditions required for a payment in due course
- To learn about the duties and responsibilities of a paying banker
- To know about the protection given in law, to a paying banker and conditions to get the protection

Structure of the Lesson :

6.1 Introduction
- 6.1.1 Who is a Paying Banker
- 6.1.2 Payment Process
- 6.1.3 Methods of Clearing Cheque

6.2 Payment in Due – Course
- 6.2.1 What is Payment in due course
- 6. 2.2 Conditions given for a Payment in due course

6.3 Duties and Responsibilities of a Paying Banker

6.4 Statutory Protection to the Paying Banker
- 6.4.1 When Protection is needed to a Paying Banker and why
- 6.4.2 Condition to get Statutory Protection by the Paying Banker / Situations at which a Paying Banker can dishonor a Cheque

6.5 Conclusion

6.6 Summary

6.7 Key Words

6.8 Self Assessment Questions

6.9 Suggested Books

6.1 INTRODUCTION :

6.1.1 Who is a Paying Banker?

Paying banker is a banker, who actually ***pays a cheque to his customer or to the order of his customer.***

For example, a customer draws a cheque on his banker. How it is done?

- First, he writes the date
- Then he indicates the name of the person to whom the cheque is to be paid.
- Then he writes the amount to be paid, in words (Eg: Rupees one Thousand Only ….etc)
- Then, the amount in figures is filled in the box (Eg. Rs. 1000/-).
- Lastly, the account holder puts his signature (Account Holder is the Bank Customer)
- The bank customer hands over the cheque to his Trade customer (Cheque is valid for three months from date of drawing)
- When the trade customer i.e person who received the cheque, take efforts to present the same ***to his bank for collection (or) to the Drawer's banker to receive payment,*** the payment process is said to have started.

6.1.2 Payment Process :

- When payment of a cheque is met, through another bank of collection, it will be easier for the paying banker, as the identity of the payee would already be fixed by the collecting banker.
- When payment a cheque is sorted across the counter i.e ***when a cash payment is requested***, the banker should exercise due diligence and ensure that there are no grounds to believe, the cheque is not owned by the person presenting across the counter. The paying banker should act in good faith and without negligence.
- ***Mostly bearer cheques are paid across the counter.*** There is also a limit for receiving cash payment. If the cheque amount is more than the limit fixed by Reserve Bank of India, then it can be paid only to the account of the payee. The payee then has to use the money only through his own withdrawals.
- In olden days, a person receiving a cheque for his settlements, ***used to deposit*** the same ***in his account.***
- ***The bank branch,*** maintain his account, ***books all the deposited cheques in his favour*** and ***sends to the original destination for payment*** i.e to the bank / branch on which the cheque was originally drawn. The sending of cheques were mainly made ***through post or courier for out station cheques*** and ***to clearing in case of local cheques.***

6.1.3 Methods of Clearing Cheque :

- This process was to done with mere manual effort i.e only by men at a time. Otherwise, man used machines also to complete this process.

- In olden days, Calculators / Adding machines are used in this process. They are general purpose machines.
- Now-a-days machines specially designed for clearing of cheques (whether Local or Outstation) are used by bankers. By using that machines, various Electronic Clearing Systems are practiced.
- Such kinds of clearing are ***MICR Clearing, Speed Clearing***, ***"Express Cheque Clearing Systems"*** (ECCS), and ***"Cheque Truncation System"*** (CTS)
- CTS (Cheque Truncation System) is a much advanced method of paying and collecting cheques. In CTS clearing, the presenting bank will truncate the cheque and send the captured electronic image of the clearing instrument with MICR data to the Clearing House. The House process the data, arrives the settlement figure and routes the image and requisite data to the Drawee Banks.

Because of this modern technology clearing of cheques has been made most easy and error proof.

6.2 PAYMENT IN DUE – COURSE :

A banker's payment should always be a payment in due course.

6. 2.1 What is payment in due course ?

Payment in due course has been clearly defined in see.10 of the Negotiable Instrument Act, 1881. It is the manner in which a paying banker should make payment to a cheque presented to him.

See.10, defines "payment in due course" as "payment in accordance with the ***apparent tenor of the instrument,*** in good faith and without negligence to 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 definition gives clearly the conditions, the paying banker has to fulfil before making payment of any cheque. If he fulfils the same, the paying banker gets the statutory or legal protection under NI Act (Negotiable Instruments Act).

6.2.2 CONDITIONS GIVEN FOR A PAYMENT IN DUE COURSE :

Payment in accordance with apparent tenor :

"Apparent tenor" means the instruction written on the face of a cheque. Everything written on a cheque is an instruction to the paying banker.

i) Date on the cheque leaf :

It instructs the banker that, the cheque can be paid from the date mentioned therein, till expiry of 3 months from it, provided all other factors are favourable.

Example : There is sufficient balance in the account. The Signature of the drawer tallies etc.

ii) Name of the Payee :

Example "pay to Ram & Co or Order" instructs the banker to pay the cheque amount only to Ram & Co.

iii) Amount in words and figures :

Both the amounts, mentioned on the cheque should tally.

Example : (Rupees one thousand only)

Rs. 1000/-

It instructs the paying banker that only an amount of one thousand should be paid for the cheque.

iv) Signature of the Drawer :

The banker should verify the signature of the Drawer (i.e) Account Holder on the cheque, with that one in his records and confirm the genuineness of making of cheque.

[The banker gets the Specimen Signatures of the account holder on opening the account. That signatures are scanned and kept in the computer for further reference. Signatures can be verified with the original opening card also]

The banker should follow the "apparent tenor" of the instrument and act accordingly.

In Good Faith :

"Good Faith" means the right belief of the paying banker on the ownership of the cheque.

The banker should be certain that the person presenting the cheque is the true owner of the cheque.

Without Negligence :

The paying banker has to go through the contents of cheque carefully. If there is any alteration, overwriting or cancellation, cheque can not be paid. If a banker pays an altered cheque, it is negligence on his part.

The maker of the cheque can authenticate and make good of the alterations on the cheque, by putting his full signature near the altered portion. But now, Reserve Bank of India, does not allow alteration on cheque, except for dates. Otherwise, the payee has to get another cheque from the original owner of the cheque, instead of the altered one.

To the Person in Possession :

A paying banker should pay a cheque only to the person, having possession of the instrument. Possession is a must for a holder-in-due-course.

So, paying banker ***should make payment*** only to that person, ***who is in possession*** and ***presents the cheque for payment.***

Circumstances :

Some time there arises a situation that, though the person presenting the cheque may fulfil all the conditions, there may be a reasonable ground for the banker to doubt the true ownership of the person, for the cheque.

For example, A banker is supposed to know all details about his customer as he receives "***Know Your Customer*** (KYC)" details at the time of opening of a bank account. A customer, has transacted only in hundreds in his account previously. One day, he deposits a cheque of Rs. 10 lacs into his account. His occupation is also not in a manner to receive a cheque amounting Rs. 10 lacs. The banker should compulsorily enquire into this matter, as he can assess that his customer has rare chances of getting that much money in normal course.

Sometimes, the transaction may be a genuine one, on the grounds that, the customer got a lump sum money from ancestral property etc. But the banker has to clarify the same rightly, before entertaining payment of the cheque. Failure to do so, is a negligence on the part of the paying banker. Such ***payment made, without proper clarification is said to be "against payment in due course"***.

6.3 DUTIES AND RESPONSIBILITIES OF A PAYING BANKER :

A banker has an ***obligation to honour cheques of its customer, drawn on him*** and ***presented for payment, subject to the condition*** that ***there are sufficient funds*** in the accounts and ***the cheque is in order.***

Section 31 of the Negotiable Instruments Act 1881, provides that "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 to do so and in default of such payment must compensate the drawer for any loss or damage caused by such fault.

So, it is the bounden ***duty of a bank to honour its customer cheques,*** after taking some precautions. In other words, ***the paying banker is under an obligation to honour cheque subject to some conditions, being satisfied.***

They are,

a. There must be ***sufficient funds*** in the customer's account on which cheque is drawn.

b. The funds should be ***properly applicable to the payment*** of such cheque.

c. Cheque ***should be properly drawn*** and ***should not be irregular*** (or) ***ambiguous***

d. Cheque should be ***presented during the banking hours*** of the bank

e. Cheques ***should be presented for payment within the validity period.***

Now, the validity period for a cheque is three months from the date of issue. So cheques should be presented ***within three months*** of their issue.

6.4 STATUTORY PROTECTION TO THE PAYING BANKER :

Sec. 85 of the Negotiable Instruments Act, 1881 gives statutory protection to the paying banker.

6.4.1 When protection is needed to a paying banker and why?

When? - Protection is needed when the paying banker dishonours cheque of his customer, on genuine grounds.

Why? - It is the bounden ***duty of the banker to honour the cheques,*** drawn on him and duly presented for payment. So, ***if he dishonours the*** cheque or ***make any wrong payments, the paying banker is liable to be sued for damages.***

6.4.2 Condition to get statutory protection by the paying banker / situations at which a Paying Banker can dishonor a cheque

The banker before honouring the cheques presented to him/her for payment should look into the following points in order to safeguard himself/herself against the risk of losing the customer's money. They are,

i) ***Open or crossed cheques :*** When a cheque is presented for payment, the banker should verify as to whether it is an open cheque or a crossed one and whether the cheque is in printed form. There is no provision in the Banking Regulations Act, preventing a customer from drawing his own cheque. But the banks prefer the printed form as it is easy for verification and filing. An open cheque, if it is otherwise valid, can be paid across the counter. If it is crossed, the holder is required to present it only through another banker. The specific instruction in case of a crossed cheque is that, it should be paid through an account and not across the counter.

ii) ***Drawn on the specific branch :*** Cheques should be drawn on the particular branch at which they are presented.

In olden days a cheque can not be presented at a different branch, even of the same bank, where account is not maintained. Because the banker will refuse payment, as he doesn't know the state of the drawer's account and can not verify the signature of the customer.

This was the position, upto the period, ***where all bank works were done manually.***

Then banks were computerized one after one. At the initial stage of computerization also, only partial (or) no inter-branch transactions taken place.

Then the banks switched over to ***CBS (Core Banking Solutions)*** system.

The ***CBS system allowed inter-branch transactions*** (i.e Transactions between the branches of the same bank). The accounts opened in one branch were made accessible by all branches so that any branch can know the account balance of any customer of any branch. ***Then Inter-Bank*** (i.e from one bank to another Bank) ***transactions, electronic money transfers*** were made possible ***through use of some uniform code practices*** as agreed upon by all bankers, whether private, public or otherwise.

Some example are,

IFSC (Indian Financial System Code) followed by Society for Worldwide Interbank Financial Telecommunication (SWIFT)

UTR (Unique Transaction Reference) this is the transaction identification number in the electronic transfer of money vide

NEFT (National Electronic Fund Transfer)

RTGS (Real Time Gross Settlement)

IMPS (Instant Money Payment System) etc

iii) Mutilated Cheque :

If the banker finds the cheque presented to him is already mutilated or torn, the banker is having a right to return the cheque, with the remark "Mutilated Cheque".

When a cheque is torn accidentally, the banker can pass it for payment after obtaining the drawer's confirmation on the cheque.

iv) Date of the Cheque :

Date of a cheque is the ***most material matter in the cheque,*** as the legal validity of the cheque, itself is decided by the date. As per law, ***a cheque is valid for payment, for three months*** from the date written on the cheque i.e from the date of the cheque.

Rules Regarding Date :

- A cheque should bear a date in the column meant for it on the cheque
- Date should not be incomplete
- It should contain the day, month and year in a proper form
- It should not be ambiguous in any manner

- A post-dated cheque can't be paid by the banker, although presented properly. Because the customer may stop payment of the cheque. He may become insolvent or insane or may die before the due date.

If a banker paid a post-dated cheque, he loses his statutory protection.

v) Words and figures differ :

A banker can return a cheque if the amount in words and amount in figures differ. If so, he has to return it with a remark that "Amount in words and figures differ".

If, the banker decides to pay the amount in words, he has no risk. But if the amount is written in figures only, then the banker should confirmly return the cheque.

vi) Material Alteration :

Material alteration means changing the date, amount, name of the payee, removal of crossing etc. All these things affect the credibility of the instrument.

So, the banker should refuse payment of a materially altered cheque. If the drawer confirms the alteration by putting his full signature near the alteration, banker can entertain payment of cheque. But now Reserve Bank of India does not allow alteration of any part of cheque, except date.

vii) Specimen Signature :

Specimen signature is a signature of the customer, got by the banker at the time of account opening. Banker keeps the specimen signature, in manual records as well as in computer (The scanned signature of the account holder is uploaded to the computer for future reference).

Whenever a banker receives his customer's cheque presented for payment, he should verify the signature in the cheque, with that ones in his records. ***If the signature of the customer on cheque differs from the specimen signatures furnished to him, the banker should return the cheque.***

Rules regarding Specimen Signature :

a) A ***Bank customer is supposed to adopt same style of signature as per his/her specimen signature.*** Later, if he adopts a different style of signature other than that of specimen signature, it is his duty to inform the bank about the change and has to give new specimen signature records, and also the effective date of the new specimen signature. Otherwise, banker can return the cheque with the remark "Signature Differs".

b) ***The signature on the cheque, should not be followed by date.*** If the signature bears a date below it the banker has right to return it.

viii) Proper Endorsement :

Before paying the cheque presented to him, the banker should see whether there is any endorsement on it and if so, whether it is regular or not.

ix) Insufficient Funds :

The banker is under an obligation to pay his customer's cheque, provided there is sufficient or enough funds in customer's account to meet out the cheque. But ***if there is no sufficient funds, the banker is not bound to honour the cheque.***

Rules to decide availability of funds :

1. ***The minimum balance required to maintain a savings bank or current account is deemed to be available for honouring the cheques*** of the account holder. Though the actual balance gets reduced below the prescribed minimum amount, the banker should honour the cheque and may recover charges from the customer, for the non-maintenance of minimum balance.
2. In case a banker already granted an overdraft or cash credit limit to a current account holder, the amount available for passing a cheque includes the original balance in the account plus the amount sanctioned as overdraft or cash credit.

x) Chronological Order of Payment :

Normally, Banker follow "First in, First Served", method in passing a customer's cheques. It means payment of cheque will be made in the order of their receipt. The first received cheque should be first paid out, the second – received cheque secondly and so on.

Availability of account balance for passing a cheque will be assessed as such.

xi) Garnishee Order :

A Garnishee order is a court order, directing a third party (i.e Garnishee) to pay money of a judgement debtor with him, to a judgement creditor. Here the banker is the "Garnishee".

If he received a Garnishee order against a bank customer, the banker has to lock the customer's account upto the amount mentioned in the Garnishee order.

So, in this situation, banker can not pay other cheques, even if there is sufficient balance in the customer's account. The banker also gets the statutory protection for a dishonor of cheque, in obliging a Garnishee order from court.

xii) Inchoate Cheque :

If a cheque is incomplete with regard to date, amount payee or drawer's signature, then it is called an "Inchoate Cheque". If a banker receives an "Inchoate Cheque", presented for payment, he has to dishonor the same for want of details to be filled. In this

situation, ***the banker is not liable, for dishonour of the cheque, even if sufficient balance is available in the account.***

So, in all the above – discussed occasions, the banker gets statutory protection, even though he dishonours a customer's cheque (for there is a genuine reason in all situations, for the cheque dishonour).

6.5 CONCLUSION :

From the above discussions, it is very much evident that, as long as a paying banker observes the guidelines given in section 10 of Negotiable Instruments Act, 1881 i.e conditions for a payment in due course, he can avail the legal protection available through see. 85 of the Act, for paying banker.

6.6 SUMMARY :

Paying banker is a banker, who actually pays a cheque to his customer or to the order of his customer. It includes payment process. There are different methods for clearing cheque. In this lesson we are going to know about the payment in due course which means payment in accordance with the apparent tenor of the instrument. It gives clearly the conditiond, the paying banker has to fulfil before making payment of any cheque.

Paying banker has some duties and responsibilities, a banker has an obligation to honour cheques of its customer, drawn on him and presented for payment, subject to condition. Sec. 85 of the Negotiable instruments Act,1881 gives statutory protection to the paying banker.

6.7 KEY WORDS :

Bearer Cheques :

It is a method of payment where the cheque is made out to the owner or bearer of the document.

Clearing Cheques:

The check is in order and therefore can be debited from the drawer and credited to the payee.

Express Cheque :

A premium service where by cheques are cleared between 11am and 12 pm (on working days) and clients can receive their funds after the session ends as 3pm on the same day.

Payment In Due Coures :

Payment in due course" defines payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession.

Apparent Tenor :

Apparent tenor" means the instruction written on the face of a cheque.

Cheque Leaf :

A single cheque from a chequebook is called a cheque leaf.

Drawer :

The maker of a bill of exchange or cheque is called the "drawer".

Good Faith :

An element of good faith would be "fairness in dealings between contracting parties" and it "is wider than that of honesty".

Negligence :

Negligence is the failure to behave with the level of care that a reasonable person would have exercised under the same circumstances.

KYC :

Know Your Customer (KYC) standards are designed to protect financial institutions against fraud, corruption, money laundering and terrorist financing.

6.8 SELF ASSESSMENT QUESTIONS :

1. Who is a Paying Banker?
2. What is Material Alteration of a cheque?
3. What do you mean by a Open Cheque?
4. Can a banker honour an "Inchoate Cheque"? Why?
5. Explain "payment in due course".
6. What are the duties of a Paying Banker?
7. Enumerate the conditions under which a banker can dishonor a customer's cheque, presented for payment

6.9 SUGGESTED BOOKS :

1. Control of Commercial Banks in India, Dr. Mohammad Quddus.
2. Sinkey, J.F., Commercial Bank Financial Management, Prentice Hall, New Delhi, 2002.

V. Sakunthala

LESSON – 7
COLLECTING BANKER

Objectives :

- To understand who is a collecting Banker
- To know about conversion of a cheque
- To understand provisions of sec. 131 of NI Act (Negotiable Instruments Act), 1881, giving protection to collecting banker
- To understand the conditions under which the collecting banker gets statutory protection.
- To know the Duties of a collecting banker

Structure of the Lesson :

7.1 Who is a Collecting Banker

7.1.1 Meaning of Collecting Banker

7.1.2 Documents that a banker collects

7.1.3 Procedure of collecting a cheque

7.1.4 Capacity of collecting banker

7.2 Conversion of a Cheque

7.3 Statutory Protection to the Collecting Banker

7.4 Conditions on which a Collecting Banker can get protection

7.5 Duties of a Collecting Banker

7.6 Conclusion

7.7 Summary

7.8 Key Words

7.9 Self Assessment Questions

7.10 Suggested Books

7.1 WHO IS A COLLECTING BANKER :

7.1.1 Meaning of Collecting Banker :

According to Sir. John Paget, one of the main functions of a banker is "***Collecting cheques crossed or uncrossed for its customer***"

In the ordinary course of any business, people used to buy and sell products, services, raw materials, semi-finished goods and even events. For settlement of the purchases, everybody used to issue cheques, for, cash payment is not passible in all situations. Another reason is that it is not safe to deal in cash always. Sometimes, the seller offers credit to the buyer. In modern business world even buyers and sellers in very remote areas are transacting with each other because of the colossal development in the field of communication. So, everyone cannot pay cash, one to one, and the use of cheques, bill of exchanges and other modes of electronic payments are made necessary.

So, when cheques and bills of exchange become the more preferred mode of trade payments and others, ***the necessity of a mediator, with knowledge and expertise, to collect that money for the true owner of the cheque is also felt much.*** He is the Collecting Banker.

A Collecting Banker undertakes to collect cheques, drafts, bills, pay orders, traveller's cheque, Letter of credit, dividend warrants, debenture interest etc, on behalf of the customer.

For collecting these documents, the collecting banker used to charge some commission. The Rate of this collection commission for local cheques, outstation cheques etc, are fixed on the guidelines of Reserve Bank of India, then and there.

7.1.2 Documents that a banker collects :

a) Cheques
   - Local Cheques [Inter-Bank (means among various banks), Intra-Bank (means with in a bank]
   - Outstation Cheques (Inter-Bank, Intra-Bank)

b) Drafts (Inter – Bank, Intra – Bank)

c) Bills of Exchange
   - Documents against payment
   - Documents against acceptance
   - Foreign bills

d) Pay orders / Gift cheques

e) Traveller's cheque

f) Letter of credits

g) Dividend warrants

h) Interest certificates (for debentures, bonds etc)

7.1.3 Procedure of collecting a cheque :

a) The customers are depositing, various instruments to be collected from other banks, to his banker (i.e the bank in which he is holding account)

b) The collecting banker segregates all the cheques / instruments to be collected into (a) ***Local instruments,*** that also into instruments to be collected from other branches of his own bank and instruments that are to be collected from other local banks, (b) ***outstation instruments,*** that also into, instruments to be collected from branches of his own bank, situated in other towns cities and villages and instruments to be collected from other outstation banks.

c) Local cheques of the same bank are collected through ***messenger service*** (i.e a person will be sent to other branches of its own bank in the local city and the money will be collected as per the bank procedure) (or) even through ***clearing service*** (i.e all local banks will meet in a common place called "Clearing House", exchange instruments, related to them, and pay them duly).

Thus, ***the cheques of all local banks are collected through clearing service.***

d) The outstation cheques, whether inter-bank or intra-bank are booked by the banker and sent to the respective branches in case of intra-bank cheques (i.e within one bank). In case of other bank cheques, the collecting banker used to send the cheques, not to the Drawee bank, but to another renowned bank of same locality and the cheques will be collected through clearing houses in the respective centres.

e) When collected, the proceeds will be sent to the respective bank branches, by the paying banker, on advice.

f) On receipt of the proceeds, the collecting banker, credits the proceeds to the respective accounts of customers, after deducting his commission, charges etc.

This is the circle of collection of cheques. A collecting Banker's responsibility is not merely collecting these documents but should credit the realized amount to the account of the true owner of the instrument. So collecting banker acts in two various capacities – ***he is a bailee,*** when the banker is ***in possession of customer's cheque*** and is ***a trustee,*** when he ***collects the amount for benefit of the customer.***

7.1.4 Capacity of collecting banker :

In all situations, the collecting banker acts as either "agent for collection" or "Holder for value"

Agent for collection:

A collecting banker acts merely as an agent of his customer, when

a) Banker receives the cheque for collection

b) Sends to the paying Banker for realization of the cheque

c) Receives the proceeds (i.e) realized amount

d) Credits to the customer's account after charging the collection expenses, his commission etc.

In this case, the banker acts just an agent of the principal i.e his customer. Here, the collecting banker is performing two functions.

i. If the cheque is realized the banker will credit the amount realised to the customer account.

ii. If the cheque is dishonoured, the banker has to inform the matter to the customer and return the cheque to him properly.

Holder for value*:*

When a collecting banker, advances some amount to his customer, before realisation of his cheque, the banker becomes owner of the cheque now and he is termed as "Holder for value".

(i.e person holding the cheque, for the value paid to the (or) true owner of the cheque, before realisation of the instruments)

As holder for value :

The collecting banker is said to acting as holder for value,

i. When the collecting banker advances money to the customer before the realisation of the cheques given for collection.
ii. When the collecting banker settles the loan amount due from the customer with the cheque amount given for collection, even before its realisation.
iii. Where a collecting banker reduces an overdraft with the amount for collection before its realisation.
iv. Where a part of the cheque amount is given by the collecting banker to the customer even before the realisation of the cheque.
v. By allowing the customer to draw the full amount of the cheque before its realisation.

7.2 CONVERSION OF A CHEQUE :

A collecting Banker is always supposed to collect a negotiable instrument for a customer, who is the true owner of the instrument. To assess whether the customer is the true owner of the instrument, the banker should scrutinize the instrument in a very careful manner and ensure that the apparent tenor of instrument proves that the customer is the true owner of that instrument.

If the collecting banker, either by negligence or by mistake collects and credits the

account of a wrongful owner, the collecting banker is said to have committed the offence of "Conversion".

"Conversion" means wrongful or unlawful interference with another person's property which is not consistent with the owner's right of possession. So, a collections banker should not entertain documents on which his customer has no title or defective title.

7.3 STATUTORY PROTECTION TO THE COLLECTING BANKER :

Statutory protection or Legal Protection is given to a Collecting Banker in sec. 131 of the Negotiable Instruments Act, 1881.

Sec. 131says,

- A banker who has in good faith
- received payment for a customer of a cheque
- crossed generally or specially to himself
- shall not, in case of title to the cheque proves defective
- incur any liability to the true owner of the cheque
- by reason only of having received such payment

This statement in sec. 131 shall be elaborated as conditions to get statutory protection for a Collecting Banker.

7.4 CONDITIONS ON WHICH A COLLECTING BANKER CAN GET PROTECTION :

UNDER SEC. 131 OF THE NI ACT, 1881

If the following conditions are fulfilled, a collecting banker can get protection under sec. 131 of Negotiable Instruments Act.

a) Collecting for a Customer :

A banker must collect a cheque or any other form of Negotiable Instrument only for a customer. Here, customer is predicted as one who has opened a savings bank or current account with the banker. Then also ***to come under the purview of the term "Customer" under section 131, those savings or current account should have proper introduction, as required by law.*** A savings bank account may be introduced by another savings bank account holder of the same branch of the bank. But a current account can be opened only when letter of introduction has been given by another current account holder or by an employee of the bank not less than that of an officer or by persons of well – reputation and who are well – known to the banker.

If a current Account is opened without proper Letter of Introduction, then it amounts to violation of sec. 131. The Banker can not get legal protection, when he collects cheque and such other instruments for such a customer.

b) The cheque presented to the bank for collection should be crossed generally or specially :

In the capacity of "agent for collection", the banker collects the cheque on behalf of his customer, that also when presented to him.

If a customer gives an open cheque i.e a cheque uncrossed, the banker has to cross the cheque before it is sent for collection. Then only, he can claim protection under sec. 131.

c) In good faith :

"Good Faith" means ***good faith on the ownership of the cheque.*** The collecting banker should accept cheque for collection only on good faith i.e there should not be any grounds to doubt the ownership of the customer on the cheque. Otherwise, there should not be any ambiguity on ownership of the cheque.

If any doubt arises, the banker should clarify it, before proceeding for the collection of cheques.

Example : A cheque, for Rs.10 lacs favouring "N. Murugan" is deposited by the customer named N. Murugan, whose account has previous tranctions in the range of hundreds and thousands only and his occupation is also not in a position to receive such a big amount. In this case, the collecting banker should enquire the customer, should ensure source of such income and that the customer is the true owner of the instrument.

d) Without Negligence :

In common terms 'Negligence' means failure to take proper care over something. In legal terms it is a "breach of a duty of care which results in damage"

On undertaking to collect a cheque for a customer, if the collecting banker fails to exercise utmost care in fixing the ownership of the customer on the cheque, he is said to be negligent on his duty. Then the collecting banker is due for damages to the true owner of the instrument and is also losing the protection under section 131.

e) Agent for collection :

Section 131 gives statutory protection to the collecting banker only when he acts as "agent for collection" and not as a "holder for value".

As an agent, the collecting banker credits the account of the customer, only after realisation of the cheque. In such case only, he can avail the protection under 131, provided he acted in good faith and without negligence.

7.5 DUTIES OF A COLLECTING BANKER :

In a normal course, a collecting banker is expected to perform three major duties towards his customer.

a) Quick clearance of collection instruments :

Whenever a customer gives an instrument for collection, the collecting banker should immediately send it to the appropriate paying Banker for further perusal and action.

On receiving a cheque for collection, the collecting banker affixes seal on the pay-in-slip. The seal normally contains the name of the bank, branch and the date of receipt of the instrument. This is done for ensuring that the instrument received has been sent for collection on the date of receipt itself.

When it is not possible to send the cheque for collection on the same day, the collecting banker has to affix a seal, containing the words "Too late for today' Collection", so that the banker escapes the liability for any delay in collection. Undue delay in collecting of instruments, will lead to hardships to the customers. The customer may not able to meet out his further trade payments, because of the delay incurred in collection of cheques, deposited to his account. Then the banker will be pushed to a position, as to pay compensation to his customer.

b) Acting as Bailee :

According to sec. 148 of contract Act, ***Bailment*** is the ***delivery of goods,*** by one person to another ***for some purpose,*** upon a contract that they shall, ***when the purpose is accomplished be returned or otherwise disposed of*** according to the direction of the person delivering them.

The person who delivers the goods is called "Bailor". The person who receives the goods (for some purpose) is called "Bailee" and the contract between them is called "Bailment".

In case of collection of cheques or other instruments, the customer delivers the goods i.e the cheque or instruments for the purpose of collecting the same and crediting to his account. So, here the cheque-depositing customer is called the "Bailor". The cheque is delivered to the collecting banker, so he is called "Bailee". The collecting banker acts as a bailee until the cheque is realised and the proceeds are credited to the account of the customer.

As a bailee of goods i.e cheques or other instruments for collection, the collecting banker performs two functions as explained by sec. 148 of the contract Act

- ***Executes the purpose*** for which the instruments are deposited, that means collecting the instruments and duly crediting the customer's account. ***Here, the instruments are disposed of,*** as per instructions of the customer.

– ***In case of dishonour of the cheque,*** i.e the cheque has been genuinely returned for one or other reason, the collecting banker performs the duty to return the dishonoured cheque to the customer. Normally, the collecting banker used to get the signature of the customer in a separate register for return of the dishonoured cheques.

c) To collect cheques without Negligence :

As already explained, "Negligence is failure to take proper care over something". Negligence on the part of a collecting banker may be of different nature.

What constitutes Negligence on the Collecting Banker :

i. When a banker ***has not obtained proper Letter of Introduction*** for opening a current account.

ii. A ***crossed cheque*** has been ***paid across the counter*** by oversight

iii. An ***account payee cheque*** was collected and ***credited to the account of a person other than the true owner of the cheque.***

This amounts to negligence on the part of the collecting banker and also he has performed the offence of "Conversion" of cheque.

iv. In case of a cheque with "***Not-Negotiable" crossing, the collecting banker should exercise due precaution*** that, the instrument should not has not been further negotiated. Otherwise, it is taken as negligence on his part.

v. ***The banker is also convicted of Negligence, when he collects and pays a cheque where the amount of the cheque and status of the person are inconsistent.***

Example : A peon of a company, using blank endorsement of a cheque of the company, deposits a high amount cheque into his personal account. The banker without proper enquiry, credits the amount to the account of the peon. This action amounts to negligence on the part of the collecting banker and he can be sued for damages, by the true owner of the cheque.

vi. When a banker, ***opens accounts without proper enquiry.***

vii. A ***cheque belonging to a partnership*** firm has been ***credited to the individual account of a partner,*** without proper enquiry with the firm.

viii. A ***cheque received in official capacity*** of a person has been ***credited to the personal account*** of that person.

Example : A cheque may be received by Principal of a college in his official capacity. But by misusing his position, if he endorses it to his personal account and presents for collection means it is the duty of the collecting banker to rightly probe the matter and deny payment to personal account, otherwise the banker will be charged of negligence on his part.

ix. Some times ***a customer may have accounts in two different branches of the same bank.*** Both the branch managers has ***to ensure the status of the two accounts and the necessity for the same.*** Otherwise, the customer may indulge in accomodating the cheques of two accounts and may entertain other irregular activities.

So, in all the above cases, the banker is said to have been negligent on his part, which should be avoided.

7.6 CONCLUSION :

From, all learnt above, we shall conclude that a collecting banker has to exercise utmost care in collecting instruments for his customer. He is having equal responsibility as that of a Paying Banker.

A collecting banker can get statutory protection under 131 of NI Act, 1881, provided the conditions stated in the section are properly complied with.

7.7 SUMMARY :

A collecting banker undertakes to collect cheques, drafts, bills, pay orders, traveller's cheque, letter of credit, dividend warrants, debenture interest etc, on behalf of the customer. For collecting these documents, the collecting banker used to charge some commission. There are different documents that a banker collects.

It has some procedures to collect those documents like cheque. The collecting banker has to exercise utmost care in collecting instruments for his customers. He is having equal responsibility as that of a Paying Banker.

7.8 KEY WORDS :

Collecting Cheques :

In case a collecting banker has realized the cheque, he should pay the proceeds to the customer as per his (customer"s) direction.

Intra Bank :

Intra – bank refers to transactions between parts of the same bank.

Inter Bank :

Occurring between or involving two or more banks.

Letter of Credits :

A Letter of Credit (LC) is a document that guarantees the buyer's payment to the sellers.

Dividend Warrants :

An order of payment (such as a check payable to a shareholder) in which a dividend is paid.

Messenger Service :

Messenger Services means the pick up, transporting, and delivery of Mail to and from specified locations, on specified days and times.

Clearing Services :

Means the provision of clearing and settlement services in respect of any Securities and / or Derivatives.

Agent For Collection :

Collection agents work with various clients, often businesses, to resolve payment issues between them and debtors.

Conversion :

The process of changing or causing something to change from one form to another.

Bailment :

An act of delivering goods to a bailee for a particular purpose, without transfer of ownership.

7.9 SELF ASSESSMENT QUESTIONS :

1. Who is a collecting Banker?
2. Which amounts to conversion of a cheque?
3. What is Negligence?
4. How a collecting Banker acts as a bailee?
5. When a collecting banker can avail protection under sec. 131 of the NI Act?
6. What are duties of a Collecting Banker?
7. List out the occasions on which negligence has said to have happened on part of a collecting banker.

7.10 SUGGESTED BOOKS :

1. Traded Progress of Banking in India, Govt. of India, 2005-06.
2. Palfreman, D. and Ford, O.: Elements of Banking 1 and 2, Macdonald ad Evans Publications, Estover, 1985.

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LESSION – 8
DISHONOUR OF CHEQUE

Objectives :

- To understand Circumstances under which a banker can refuse payment of cheque
- Dishonour of cheque and reasons
- Legal consequences of dishonour of cheque

Structure of the Lesson :

8.1 Introduction
8.2 Circumstances under which a Banker can refuse Payment of Cheques
8.3 Dishonour of Cheque
8.4 Consequences of dishonour of Cheque with reasons
8.5 Reasons for dishonour of Cheque
8.6 How to avoid dishonour of Cheque
8.7 Legal Provisions
8.8 What amounts to dishonour of Cheque
8.9 Notice of dishonour
8.10 Liability of a drawer of a dishonoured Cheque
8.11 Conclusion
8.12 Summary
8.13 Key Words
8.14 Self Assessment Questions
8.15 Suggested Books

8.1 Introduction :

Advent of cheques in the market have given a new dimension to the commercial and corporate world, its time when people have preferred to carry and execute a small piece of paper called Cheque than carrying the currency worth the value of Cheque. Dealings in cheques are vital and important not only for banking purposes but also for the commerce and industry and the economy of the country. But pursuant to the rise in dealings with cheques also rises the practice of giving cheques without any intention of honoring them. Cheques are used in almost all transactions such as re-payment of loan, payment of salary, bills, fees, etc. A vast majority of cheques are processed and cleared by banks on daily basis. Cheques are issued for the reason of securing proof of payment. Nevertheless, cheques remain a reliable

method of payment for many people. On the other hand, it is always advisable to issue crossed “Account Payee Only” cheques in order to avoid its misuse. A Cheque is a negotiable instrument. Crossed and account payee cheques are not negotiable by any person other than the payee. The cheques have to be deposited into the payee's bank account. Legally, the author of the Cheque is called drawer, the person in whose favour, the Cheque is drawn is called payee, and the bank who is directed to pay theamount is known as drawee. However, cases of Cheque bounce are common these days. Sometimes cheques bearing large amounts remain unpaid and are returned by the bank on which they are drawn.

8.2 CIRCUMSTANCES UNDER WHICH A BANKER CAN REFUSE PAYMENT OF CHEQUES :

The person who performs the banking activities such as accepting of deposits, lending money, withdrawing facilities, exchanging of money is known as a banker. In other words, the person who directly related to the banking business is called banker.

Cheques are a form of payment that is recorded by accountants on your receivables ledger. While you may record the payment instantly upon receipt, there will be a lag time between when you record the payment and when the check clears the bank and is posted to your account.

The Banker must, therefore, refuse payment of the cheques without incurring the liability.

When the drawer countermands payment :

- A cheque has been lost by him.
- Stop payment must be signed by the drawer.
- Change number and date must mention.

When the account is closed :

When the customer gives notice to the banker for closing his account, the banker must not pay the customer's cheques after that date, i.e., the date of closing of the account.

When the banker has received a Garnishee order :

Garnishee order implies a prohibiting order by a court of law attaching the funds in the customer's account. On receipt of such order, the banker must refuse the payment of the customer's cheque. If the banker by mistake makes payment of any cheque after receipt of such order, it will have to bear the loss itself. In this case it cannot recover from the payee who gets payment of an otherwise valid cheque.

When the customer has countermanded payment :

If a customer countermands payment, i.e., issues instructions to his / her banker not to pay or honor, i.e., ‘stop payment’ of a particular cheque issued by him / her, the banker is bound to comply with such instruction. It is important to note that the customer must duly

sign the countermand notice, which should contain correct particulars of the cheques and give to the banker in sufficient time, i.e., before the banker makes the payment of the cheque that is desired for 'stop payment'. However, it is not necessary that such a notice be given in writing always. An oral countermand is equally effective.

Where the instrument has been materially altered :

When there is a material alteration on the instrument or where the signature of the drawer does not match with the specimen signature kept by the banker, the latter must dishonor such cheques. However, in case of payment by mistake, the banker is entitled to a refund from the wrong payee if traceable, failing which the banker will have to bear the loss itself.

When the banker has come to know of any defect in the Title :

When the banker comes across any defect in the title of the person presenting the cheque, it must refuse to honor the cheque. Even the holder of a bearer cheque is subject to this rule and the banker should insist on identification of the presenter in the event of any suspicion or doubt about the integrity of the possessor of the instrument.

When the customer has lost the instrument :

When the customer has lost the cheque and has informed the banker about the loss of the instrument, the bank must, in turn, dishonor the cheque.

Where the banker has received a Notice of Assignment :

When the banker receives notice of assignment from the customer about his credit balance, it must refuse payment of the cheque(s) drawn by that customer.

When the customer has become insolvent or insane :

A banker must also refuse payment of cheques when its customer has been adjudged insolvent or has become insane since in such cases its original authority to pay on behalf of the customer ceases to exist. A fresh authority is required on those accounts. If a banker makes any payment even after receiving a due notice as regards insolvency or insanity of the account holder, such payment is not good against the drawer and in such a case the banker cannot get a refund from the payee, who gets payment of an otherwise valid cheque.

When the customer has died :

If the banker receives notice of a customer's death, it must dishonor the cheque presented to it after the notice of death. However, a banker is justified in making payment if such payment is made before receiving the notice of death and the payment so made is valid.

8.3 DISHONOUR OF CHEQUE :

If the bank denies to pay the sum to the payee, the cheque is said to be dishonoured. In other words, dishonour of cheque could be a condition in which bank denies to pay the sum of cheque to the payee.

When a cheque is dishonoured, the drawee bank quickly issues a 'Cheque Return Memo' to the banker of the payee saying the reason for non-payment. "The payee's investor at that point gives the dishonoured cheque and the notice to the payee. The holder or payee can resubmit the cheque inside three months of the date on it, in case he accepts it'll be honoured the second time". Be that as it may, on the off chance that the cheque issuer comes up short to form a installment, at that point the payee has the correct to indict the drawer lawfully. The payee may lawfully sue the defaulter / drawer for disrespect of cheque as it were on the off chance that the sum said within the cheque is towards release of a obligation or any other risk of the defaulter towards payee. If the cheque was issued as a gift, towards loaning a advance or for illegal purposes, at that point the drawer cannot be arraigned in such cases.

8.4 CONSEQUENCES OF DISHONOUR OF CHEQUE WITH REASONS :

Cheques are utilized in nearly all exchanges such as re-payment of credit, installment of compensation, bills, expenses, etc. An endless lion's share of cheques are handled and cleared by banks on every day premise. Cheques are issued for the reason of securing verification of installment. All things considered, cheques stay a dependable strategy of installment for numerous individuals. On the other hand, it is continuously prudent to issue crossed "Account Payee Only" cheques in arrange to dodge its misuse.

A cheque is a negotiable instrument. Crossed and account payee cheques are not negotiable by any person other than the payee. The cheques ought to be kept into the payee's bank account. Legally, the creator of the cheque is called 'drawer', the individual in whose support, the cheque is drawn is called 'payee', and the bank who is coordinated to pay the sum is known as 'drawee'. However, cases of cheque bounce are common these days. Some of the time cheques bearing expansive sums stay unpaid and are returned by the bank on which they are drawn.

8.5 REASONS FOR DISHONOUR OF CHEQUE :

- In case the cheque is overwritten.
- In case the signature is missing or the signature within the cheque does not coordinate with the example signature kept by the bank.
- In case the title of the payee is missing or not clearly written.
- In the event that the sum composed in words and figures does not coordinate with each other.
- On the off chance that the drawer orders the bank to stop installment on the cheque.
- In case the court of law has given an arrange to the bank to stop installment on the cheque.

- In the event that the drawer has closed the account some time recently showing the cheque.
- If the fund within the bank account is inadequately to meet the installment of the cheque.
- In case the account number isn't specified clearly or is through and through absent.
- If the bank gets the data with respect to the passing or insanity or bankruptcy of the drawer.
- If any modification made on the cheque isn't demonstrated by the drawer by giving his/her signature.
- In case the date isn't specified or composed inaccurately or the date specified is of three months some time recently.

8.6 HOW TO AVOID DISHONOUR OF CHEQUE :

Know your balance : Check your accessible adjust frequently. Utilize fund apps and content messages together with your bank to get it when cash clears out your account.

Keep a buffer : Continuously take off a few additional cash in your checking account for unexpected costs. That can assist you when require cash critically. That cash can offer assistance after you forget about installment that hit your account. In case you continually keep your account adjust over zero, you're more likely to pay overdraft charges.

Balance your account : Continuously check your account adjust, store and withdrawals. In case you adjust your account, at that point you'll have the knowledge around your account some time recently your bank does.

Communicate to the payee : If you compose a cheque and afterward on you realize merely don't have adequate sum in your account for installment, at that point you'll be able contact to the payee quickly let the payee know some time recently he store the cheque and make other courses of action. This will spare time and cash for both of you.

Cheques are used in almost all transactions such as re-payment of loan, payment of salary, bills, fees, etc. A vast majority of cheques are processed and cleared by banks on daily basis. Cheques are issued for the reason of securing proof of payment. Nevertheless, cheques remain a reliable method of payment for many people. On the other hand, it is always advisable to issue crossed "Account Payee Only" cheques in order to avoid its misuse. A Cheque is a negotiable instrument. Crossed and account payee cheques are not negotiable by any person other than the payee. The cheques have to be deposited into the payee's bank account. Legally, the author of the Cheque is called drawe, the person in whose favour, the Cheque is drawn is called „payee", and the bank who is directed to pay the amount is known as drawee. Dishonour of the cheque is one of the major issues faced by the parties while transferring money through negotiable instruments. The Dishonour of cheques became popular and frequent in courts of law and the law relating to the same developed in such a

rapid pace covering almost several aspects which may arise in the day to day disposal of such cases by the courts.

8.7 LEGAL PROVISIONS :

A "Cheque" is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form. Explanation I- For the purposes of this section, the expressions :

a) A cheque in the electronic form means a cheque which contains the exact mirror image of a paper cheque and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

b) A truncated cheque means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further.

Physical movement of the cheque in writing :

Explanation-II- For the purposes of this section, the expression "clearing house" means the clearing house managed by the Reserve Bank of India or a clearing house recognized as such by the Reserve Bank of India.

E-cheque :

Electronic cheque (e – cheque) is the image of a normal paper cheque generated, written and signed in a secure system using digital signature and asymmetric crypto system. Simply said an electronic cheque is nothing more than an ordinary cheque produced on a computer system and instead of signing it in ink, it is signed using the digital equivalent of ink. After the coming into force of The Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002, legal recognition has been accorded to e – cheques and they have been brought at par with the normal cheques. Now a, cheque includes an e – cheque.

Dishonour of cheque for insufficiency etc, of funds in the account :

Where any cheque drawn by a person on an account maintained by him with a banker for payment of any amount of money to another person from out of that account for the discharge, in whole or in part, of any debt or other liability, is returned by the bank unpaid, either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an agreement made with that bank, such person shall be deemed to have committed an offence and shall, without prejudice. to any other provision of this Act, be punished with imprisonment for a term which may extend to two years, or with fine which may extend to twice the amount of the cheque, or with both Provided that nothing contained

in this section shall apply unless the cheque has been presented to the bank within a period of six months from the date on which it is drawn or within the period of its validity whichever is earlier. The payee or the holder in due course of the cheque as the case may be makes a demand for the payment of the said amount of money by giving a notice in writing, to the drawer of the cheque within thirty days of the receipt of information by him from the bank regarding the return of the cheque as unpaid. The drawer of such cheque fails to make the payment of the said amount of money to the payee or, as the case may be to the holder in due course of the cheque, within fifteen days of the receipt of the said notice.

8.8 WHAT AMOUNTS TO DISHONOUR OF CHEQUE?

Law on the dishonor of cheque is mentioned from section 138 to 142 of the Negotiable Instruments Act 1881 as amended by Negotiable Instruments (Amendment) Act 2015 which is as follows :

- A person must have drawn a cheque on an account maintained by him in a bank for payment of a certain amount of money to another person from out of that account.
- The cheque has been presented to the bank within the period of three months from the date on which it is drawn or within the period of its validity whichever is earlier.
- That the cheque is returned by the bank unpaid, either because of the amount of money standing to the credit of the account id insufficient to honour the cheque or that it exceeds the amount to be paid from that account by an agreement made with the bank.
- The payee or the holder in due course of the cheque makes a demand of the said payment by giving notice in writing to the drawer of the cheque within 30 days of the receipt of the information by him from the bank regarding the return of the cheque as unpaid.
- Drawee fails to make the payment within 15 days of the receipt of the said notice When a cheque is presented in the concerned bank by the drawee within the stipulated time i.e. within the three months from the date of issue the drawee bank issue, Check Return Memo to the payee mentioning the reason for non - payment.

8.9 NOTICE OF DISHONOUR :

Notice of dishonour means information about the fact that the instrument has been dishonoured. Notice of dishonour is given to the party sought to be made liable and, therefore it serves as a warning to the person to whom the notice is given that he could now be made liable. Enormous delay in giving notice of dishonour may put an end to the plaintiff’s right in respect of the dishonoured instrument.

Notice of Dishonour by Whom?

Notice of dishonour is to be given by a person who wants to make some prior party of his liable on the instrument. Therefore, such a notice may be given :

1. Either by the holder or
2. A party to the instrument who remain liable for it

Dishonour of Cheque :

A person suffers a lot if a cheque issued in his favour is dishonoured due to the insufficiency of funds in the account of the drawer of the cheque. To discourage such dishonour, it has been made an offence by an amendment of the Negotiable Instrument Act by the Banking, Public Financial Institution and Negotiable Instrument Laws (Amendment) Act, 1986.

Five ingredients of the offence under S – 138 :

The offence under Sec-138 of the Act can be completed only with the concatenation of a number of acts.

Following are the acts which are components of the said offence :

1. Drawing of the cheque,
2. Presentation of the cheque to the bank,
3. Returning the cheque unpaid by the drawee bank,
4. Giving notice in writing to the drawer of the cheque demanding payment of the cheque amount.
5. Failure of the drawer to make payment within 15 days of the receipt of the notice.

8.10 LIABILITY OF A DRAWER OF A DISHONOURED CHEQUE:

- Civil liability : Where a cheque is dishonoured, the legal position of the drawer of the cheque becomes that of a principal debtor to the holder. The holder can bring civil suit just like any creditor to recover the amount from the drawer making him liable as principal debtor.
- Criminal liability : A drawer of a cheque is deemed to have committed a criminal offence when the cheque drawn by him is dishonoured by the drawee on account of insufficiency of funds. The criminal liability of a drawer in case of dishonour of cheque is dealt in section 138 to Section 142 of Negotiable Instrument Act.

Judgments bring out the correct Legal Position :

Rakesh Nemkumar Porwal vs. Narayan Dhondu Joglekar (1993 1 CR 268) :

(1993 CRI L J 680) = (1993 MH L J 630) = (72 CC 822) DB BOM Any reason for dishonour is an offence.

J. Veeraraghavan vs. Lalith Kumar (1995 3 CRI 205) :

(1995 83 CC 853) = (1995 CRI L J 1882) MAD DB Any reason for dishonour is an offence. S. 138 of the NI Act Marginal Note stating "Dishonour of cheque for insufficiency etc. of funds in accounts" addition of word "etc." cannot be considered to be an accident. Disagreeing with Hunasikathimath case of Karnataka H.C., who following Punjab and Haryana H.C. in the case of Abdul Samad by a learned single Judge of Bombay H.C. in the case of Om Prakash (1992 (3) Crimes 3006, terming them as rigid and wooden view states: "there is no other go for us except to agree to disagree with the views expressed herein, in as much as such a view, apart from suffering from a serious infirmity of erroneous interpretation of the relevant provisions of the Act, is to frustrate the very object and purpose for which the relevant provisions had been introduced by the amending Act. It is to be noted that this sort of a view is not negligibly supported by the very title of the Chapter of penalties in case of dishonour of certain cheques for insufficiency of funds in the accounts (Emphasis supplied.) Equally important it is to note that the marginal note to sec. 138 of the Act. Top of all, such sort of a view, if accepted and followed, the statutory provisions of Chapter 17, introduced by amending Act, would become a dead letter and a non-sense situation would be created, in the sense of posing insurmountable obstacle in the free negotiability and acceptability of the cheques in the fast moving commercial transactions at regional, national.

Position on and after K. Bhaskaran vs. Shankaran:

Hon'ble Apex court in the above mentioned case of Bhaskaran held that jurisdiction to initiate prosecution lies at the following places :

- Where Cheque is drawn
- Where payment had to be made
- Where Cheque is presented for payment
- Where Cheque is dishonoured
- Where notice is served up to drawer

However, recently in case of Dashrath Rupsingh Rathod vs. State of Maharashtra, reported in MANU /SC/ 0655/ 2014 interpreted various provisions of Sec.138 of Negotiable Instruments Act and held the following :

An offence under Section 138 of the Negotiable Instruments Act, 1881 is committed no sooner a cheque drawn by the accused on an account being maintained by him in a bank for discharge of debt/liability is returned unpaid for insufficiency of funds or the reason that the amount exceeds the arrangement made with the bank. Cognizance of any such offence is however forbidden under Section 142 of the Act except upon a complaint in writing made by the payee or holder of the cheque in due course within a period of one month from the date the cause of action accrues to such payee or holder under clause (c) of proviso to Section 13813.

Pre – Requisites and Documents for filing a Cheque Bounce Case:

1. Original Cheque
2. Return Memo (Bank Slip)
3. The statutory demand notice
4. Postal receipt of the notice you had issued
5. Any other document/s with the permission of Hon'ble court having the jurisdiction to try the case
6. Original copy of power of attorney, authorizing the attorney to present the complaint.

Defence that may be taken :

If the matter is examined critically, then the following may be a set of defence that may be taken are as follows :

- Absence of a legally enforceable debt or liability.
- Cheque was not returned for the reasons constituting an offence.
- Complaint is not as per time period provided in sections 138 and 142, i.e., the plea of limitation.
- Absence of legal notice of 15 days.
- Lack of Jurisdiction.
- No return of Cheque to the payee. Compoundable Offence

By an amendment introduced in 2002, under Section 147, an offence related to the dishonour of a Cheque and every other offence punishable under the Negotiable Instruments Act, 1881 can be privately settled.

8.11 CONCLUSION :

Dishonour of the Cheque is one of the major issues faced by the parties while transferring money through negotiable instruments. The Dishonour of cheques became popular and frequent in courts of law and the law relating to the same developed in such a rapid pace covering almost several aspects which may arise in the day to day disposal of such cases by the courts16.It will make the drawer liable even though he was unaware of the insufficiency of the fund in his account within a prescribed limit of time. But the law itself provides a reasonable time for them to repay back the amount to the payee. The default made after such a period has to be considered as a criminal act as it involves an unlawful intention of not paying back the money to the deserving party. Thus, the law makes it clear that the parties while signing a cheque have to be aware of the amount of money in their concerned banks.

8.12 SUMMARY :

Dishonour of the cheque is one of the major issues faced by the parties while transferring money through negotiable instruments. Cheques are a form of payment that is recorded by accountants on your receivable ledger. While you may record the payment instantly upon receipt, there will be a lag time between when you record the payment and when you check clears the bank and is posted to your account. The banker must, therefore, refuse payment of the cheques without incurring the liability.

If the bank denies to pay the sum to the payee, the cheque is said to be dishonoured. When a cheque is dishonoured, there are some consequences of dishonour of cheque. It has different ways to avoid dishour of cheque. The dishonour of cheques became popular and frequent in courts of law and the law relating to the same developed in such a rapid pace covering almost several aspects which may arise in the day to day disposal of such cases by the courts16.

8.13 KEY WORDS :

Prohibiting Order :

A prohibiting order is similar to a quashing order in that it prevents a tribunal or authority from acting beyond the scope of its powers.

Countermands :

It means to cancel, revoke, or reverse an order that has been previously issued.

Notice Of Assignment :

A form letter that an assignee of an agreement uses to provide notice to the non – assigning party to the agreement of the assignment.

Insane :

The person should be suffering from mental illness and also have a loss of reasoning power.

Dishonour :

Dishonor is the refusal to honor and pay an instrument (e.g. a check) that is presented for payment or settlement.

Over Written :

Overwrite means the replacement of previously stored information with a pre-determined pattern of meaningless information.

Account Payee :

The account holder or the corporate entity to whom you are transferring money.

Drawee :

The party that has been ordered by the drawer to pay a certain sum of money to the person presenting the check (the payee).

Socio Economic Justice :

The removal of economic inequalities and rectifying the injustice resulting from dealing or transaction between unequal in society.

Commerce :

The exchanging, buying, or selling of things having economic value between two or more entities, for example goods, services, and money.

8.14 SELF ASSESSMENT QUESTIONS :

1. Who is a collecting Banker?
2. Which amounts to conversion of a cheque?
3. What is Negligence?
4. How a collecting Banker acts as a bailee?
5. When a collecting banker can avail protection under sec. 131 of the NI Act?
6. What are duties of a Collecting Banker?
7. List out the occasions on which negligence has said to have happened on part of a collecting banker.

8.15 SUGGESTED BOOKS :

1. Bank Financial Management, Indian Institute of Banking and Finance, Taxman’s Publications, July 2004.
2. Sinkey, J.F., Commercial Bank Financial Management, Prentice Hall, New Delhi, 2002.

V. Sakunthala

LESSON – 9
LOANS AND ADVANCES

Objectives :

After Learning reading this lesson, one should be able to

- Understand the meaning, essential characteristics, types of Loans and Advances
- Describe the Nature, Scope and Purposes of Loans
- Explain the meaning and Factors of Advances

Structure of the Lesson :

9.1 Introduction
9.2 Principles or Guidelines for Secured Advances
9.3 Considerations for Sound Lending
9.4 Factors limiting the Level of Advances
9.5 Principles of Sound Lending and Investment
9.6 Types of Securities
9.7 Loan policy
9.8 Organization of Bank Lending
9.9 Follow – Up and Supervision
9.10 Summary
9.11 Key Words
9.12 Self Assessment Questions
9.13 Suggested Books

9.1 INTRODUCTION :

Lending is one of the most important functions of banks. It is one of the oldest functions of a bank just next to the function of accepting deposits. Actually, both accepting deposits and advancing loans are known as the main functions of the bank. Accepting deposits is to create loan able funds to borrowers. Therefore, they are supportive functions of a bank. The bank creates loans on funds it accepts from the public in a form of deposits. Hence, the bank is lending, in practice, not his own money, but the public money. Therefore, the bank should take the necessary precautions while lending money so as to insure the repayment of once advanced money. Otherwise, it will be closed if the loan is not collected and money is not available at his possession to honor cheques issued by customers. In order

to avoid this problem banks develop loan policies. This enables them to follow uniformity and minimizes possible errors while lending.

This unit discusses about the meaning of a loan, its classification, loan policy, loan pricing, loan administration, etc.

Meaning of Loans and Advances :

Loans are money granted by creditor to a debtor to be paid in a future fixed period with an interest. To the debtor, loan means getting the purchasing power (i.e., money) now by a promise to pay at some time in future. In a sense, the words credit, debt and loan are synonymous: credit or loan is the liability of the debtor and the asset of the bank(creditor).

The word credit is derived from a Latin word 'credo' which means "I believe". This indicates that loans are granted on the bases of trust and belief. Advancing credit or loan essentially depends upon the confidence, character, capacity, capital and collateral of the debtor.

Classification of Loans and Advances :

One of the main questions of Banks is advancing loans to customers in different ways for different purposes and for different time span. Hence Bank Loans and advances can be classified into different categories using different criterion such as nature purpose, time, security and method of repayment.

Based on the Nature of the Loan :

A bank may make advances to traders and industrialists and others in many ways. But the main forms in which money is advanced by the bank are: loans, cash credits, overdrafts, purchase and discounting bills and call / notice loans.

- Call / Notice Loans – are types of loans that are granted for a customer for a period of from an overnight to a maximum of 14 days. It is used for temporary purposes and are granted with out securities.
- Cash Credit – it is an arrangement under which a borrower is allowed to borrow up to a certain limit against the security of tangible assets or guarantees. Thus, cash credit may be regrouped as a secured cash credit and a clean cash credit. Under secured cash credit, the customer is required to provide tangible assets as security to cover the amount borrowed from the bank. In case of clean cash credit, the customer provides the bank with a promissory note, which is signed by one or more security or securities.

In case of a cash credit, the customer need not withdraw the entire amount as in case of a loan. He can withdraw from his cash credit account any amount within the limit specified as and when required and can deposit any amount of money, which he finds surplus with him. Thus, unlike loan account, cash credit account is a running account from and to which withdrawals and deposits can be made frequently. The customer has to pay the interest only on the amount actually utilized by him and not on the limit granted. If the cash credit is a

secured one, securities furnished by the customer can be increased or decreased according to the amount withdrawn and the customer is allowed to replace one kind of security with another.

The limit of cash credit is fixed by the bank very carefully after considering a number of factors such as production, sales, inventory levels, credit worthiness of the borrower etc. A cash credit is repayable on demand though in practice the limit is available for a stipulated period. The securities offered by the borrower can be adjusted according to the amount withdrawn.

When a bank grants cash credit to a customer, it fixes a ceiling or limit beyond which the customer cannot draw but within which he can draw any amount he likes. The customer need not withdraw the amount in one lump sum; he can withdraw according to his requirements. The drawback of cash credit system is the existence of large unutilized credit limits. The unutilized portion of the credit limit is to be taken as the difference between the borrower's requirement and the average use of credit during each quarter. This portion of the cash credit remains unutilized and idle which the borrower normally do not pay interest. It will not be income-earning asset to the banker. Therefore, the banker charges a penalty rate usually 1% to compensate the loss encountered by the banker while maintaining idle cash for the benefit of the customer.

- Overdrafts : a person is said to be availing overdraft from a bank, when his account with the bank shows a debit balance. Under this arrangement, the bank allows its customer to overdraw his current account so that it shows a debit balance. Any business person can enter into this arrangement to tide over a temporary shortage of funds. The bank may take some tangible security of the borrower. The customer can draw his fund as and when he requires and repay it when it is convenient for him. The operation of overdraft is same as that of cash credit with the main difference that cash credit is a little long-period accommodation. The customer is charged interest on the amount actually overdrawn by him and not on the limit sanctioned. He will be charged no interest if he does not overdraw at all during a particular period.

In practice, the arrangement for overdraft and cash credit is identical except that in the case of an overdraft the arrangement is in relation to a person's current account. Thus, the extension of overdraft facility presupposes the existence of a current account in the name of the borrower. The banker gains from good current accounts which maintain daily cash balances. The moment the customer begins to overdraw amounts, the banker will be deprived of this benefit. The funds of the banker will be in the hands of the customer.

Overdrafts are the withdrawals made according to the convenience of the customer. A sudden spurt in withdrawals will reverse the plans of the banker. However, the banker while permitting the operation of the overdraft account fix the limit of overdraft. Hence, the bankers plan takes into account these arrangements.

Overdrafts facilitates are granted for six months time with subject to renewal up on the agreement of both parties i.e., the banker and the customer. It is used to solve temporary financial deficit by the customer. Whereas, cash credit is granted for a long period of time and used to elevate permanent financial problem of the customer.

- Purchase and Discounting of Bills of Exchange : the bank provides the customers with the facility of purchasing and discounting their bills receivable. This is a method of financial accommodation offered by the banker to the customer. The bank permits the customer to discount his bills receivable and have the value of the bills credited to his account. The bank charges on the face value of the bills. It waits till the maturity of the bill and presents it on the due date to the drawee for payment. After collection, the proceeds of the bill are appropriated towards the loan and interest due by the customer. If the bill is dishonored, the amount will be recovered from the customer.

- Loans : when a bank makes an advance in lump sum the whole of which is withdrawn in cash immediately by the borrower who undertakes to repay it in installments, it is called a loan. Here advance is made on a separate loan account to which the whole amount of loan is immediately credited. The borrower is required to pay the interest on the whole amount from the date of sanction withheld draws the full amount from the loan account or not. If he does not withdraw the entire amount, the real rate of interest will be higher than the rate of interest on cash credits and overdrafts. In some cases, the bank may also agree for the repayment of loan in installments.

A loan is different from a cash credit. Cash credit is of a continuing nature, i.e., money can be withdrawn or paid into the cash credit account and interest will be charged only on the actual credit. But in case of a loan, the interest is charged on the entire amount and a loan once repaid in full or in part cannot be drawn again. A borrower has to apply for a fresh loan if he needs funds. The second transaction will be totally distinct from the first one. Commercial Banks generally advance loans for short-terms and medium terms. Since the banks charge interest on the entire amount of loans, this way of raising funds is costlier to the customer as compared to cash credits and overdrafts.

The banker prefer loans to cash credit because of two reasons :

- The bank can charge interest on the entire amount of the loan Sanctioned or disbursed.
- Loan account involves a smaller operating cost than overdraft or cash credit because in the latter case there is a continuity and magnitude of operation.

Based on the Purpose of the Loan :

On the bases of the purpose, the loan is granted for, loans can be sorted out in to the following groups.

- Commercial Loans : they are types of loans granted for commercial purposes i.e., to facilitate transactions being made between different firms. They have a short-term life i.e., such loans are granted to fulfill short term financial problems of firms so they have short duration. They may be given to businesses so as to pay salaries, to buy raw materials, to pay expenses, or to buy commodities to be resolved.
- Industrial Loans : they are loans granted to industrialists for the purpose of constructing or buying industrial buildings and to buy other fixed assets. Therefore, they have a long – term life.
- Agricultural Loans : they are types of loans to be granted to the agriculturalists. They may be given for the purpose of buying land, cultivating and developing the land, buying tractors, fertilizer, insecticide, selected seeds, etc. They have both short life and long life. Those loans granted to acquire land to cultivate and develop the land and to buy tractors have long repayment life. Whereas loans granted for fertilizers, insecticides, selected seeds have short repayment life.
- Educational Loans : they are granted to finance education expenses of a customer.
- Medical Loans : they are granted to a customer in order to finance his medication expenses.

Based on the Period of the Loan Granted :

Loans may be granted for different span of time. Some may given for short time span and others for long time span and others for intermediate time span. Accordingly loans are divided into three groups.

- Short – term loans : they are loans usually granted for a period of time up to and less than one year.
- Intermediate loans : they are loans usually granted for a period of time of from one up to five years.
- Long – term loans : they are granted for a period of time above five years.

Note : that this way of classification seem a bit practice, otherwise there is no general rule that dictates loans to be classified on the bases of this time horizon. Different banks can set different time horizon so as to classify as short, intermediate, and long-term loans.

Based on the Nature of Security :

Loans may be classified based on their level of guarantee as secured and unsecured loans.

A. Unsecured or Clean Loans / Advances : the loan, cash credit, overdraft allowed by a bank to a business person without any security of tangible assets is known as unsecured or clean loans / Advances. It is allowed to the customer against his personal security or promissory note. When the customer is a man of outstanding reputation and sound financial

position, he may be granted a loan or allowed on overdraft by the bank on personal security. Such an advance is known as clean or unsecured advance and is granted against the promissory note of the borrower. But in order to safeguard its position, the bank may insist on the signature of one or more independent surety(ies) or guarantor(s) on the promissory note executed by such a person. In case the principal debtor does not make the payment and the bank is not able to receive full payment from the property of the debtor, it can claim from the surety or sureties.

Banks may allow unsecured advances in the following ways :

- cash credit against hypothecation of movable property.
- purchasing and discounting of bills of exchange
- purchasing and discounting of documentary bills covering exports.
- advances against promissory notes guaranteed by one or more persons of good credit worthiness.
- advances against government supply bills.

Unsecured loans are risky as in such cases, bank relies entirely on the integrity, reputation and strength of character of the borrower. Banks generally advance clean advances to big business persons who command unimpeachable reputation in the business world. Clean limit is generally granted to supplement the limit granted on a secured basis.

While granting a clean credit, a bank should be very cautious as to the character and capacity of the borrower. By character, we mean that a person has a number of attributes like honesty, integrity, and promptness in fulfilling his promises. He should enjoy good reputation in the eyes of others. The borrower's capacity is also an important factor while granting a clean limit. The borrower should have the required ability, competence and experience to invest the credit judiciously and earn profits to pay back the loan. The borrower must be competent to handle the project.

B. Secured Advances / Loans : by secured advances we mean those advances which are granted against some tangible securities apart from the promissory note of the borrower. 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. The securities against advances are also known as "collaterals". Collateral means additional and securities offered by the borrower and called collaterals because they are offered in addition to the personal security of the borrower. They can be disposed of only in the event of the failure of the borrower to repay the loans.

The value of the securities is to be taken at market price and not at the cost price or book value for the purpose of making an advance. If a customer applies for a loan of Br 400,000.00 and offers shares of the nominal value of Br 300,000.00 as security. The bank should immediately try to know the market value of the shares. Let us suppose the real value of the share is Br 200,000.00. In such a case, it is advisable for the bank to advance loan of Br

200,000.00. Bank cannot be called partly secured in this case because there is no such term in the banking practice.

This implies that the market value of the securities should be equal to or more than the amount of advance throughout the currency of the loan. That is why, banks generally restrict the loan up to 60 to 70 percent of the market value of the security offered.

Collateral securities, which are offered in addition to the personal security of the borrower against an advance made to him may take any form of the following.

- any security in physical form lodged by the borrower or a third party as also the guarantee given by a third party.
- two or more securities which cover the same debt, e.g., hypothecation of goods and mortgage of property.
- third party guarantee given in addition to the borrower's guarantee. This would enable the banker to recover the maximum amount possible form the estate of the borrower by claiming the full amount of the advance (or by reducing the amount of any direct security deposited) and thereafter utilizing the third party security for making good the deficit in the amount, if any.

9.2 PRINCIPLES OR GUIDELINES FOR SECURED ADVANCES :

An important function of a bank is lending of money to commerce and industry. Money is generally lent to the individuals and organizations in the form of secured advances. The bank earns interest over these advances, which is an important source of income for it. But at the same time, the bank undertakes to entertain so many risks associated with the advances. In order to avoid these risks a bank has to follow some general principles while lending money. The most important principles of sound lending are liquidity, profitability and safety.

Liquidity is important to ensure that the demands of the depositors are met easily. Profitability is essential to meet the expenses of the bank and to earn sufficient profits. Lastly, the advances should be made to those parties, which are likely to repay them along with the interest. Safety of the funds is very essential for the survival of the bank. In order to follow this principle, banks insist on securities against the various types of advances. But, however, a bank is not merely guided by the security. To cover up the advance, it is guided by many other considerations. These considerations can be discussed as follows :

- Credit – worthiness of the borrower : The fundamental principles on which credit is based is the credit worthiness of the borrower. Credit-worthiness of the borrower is based on his reliability, responsibility and resources. The bank should give loan to the person who is reliable and a man of integrity and has the intention to repay the loan. He must be a responsible person, otherwise he will mis-utilize the loaned and will not repay it. Mere reliability and responsibility

are not enough. He must have adequate resources also. If some loss takes place, he should have the capacity to bear it. Thus, the first principle requires that a bank must satisfy itself that the proposed borrower is honor, reliable, responsible and financially sound.

- Financial position of the borrower : A bank must examine the financial position of the prospective borrower. It should ask for the profit and loss account and balance sheet of the last few years. This will help the bank to know the nature of the business and liquidity position of the assets of the borrower. Sound financial position of the borrower is necessary to be sure that the borrower has the capacity to repay the loan.

- Purpose of the loan : A bank must examine the purpose for which the loan is required. The loan must be granted to increase the income earning capacity of the borrower because, otherwise, he will not be able to pay back the loan. If a loan is granted to repay an existing debt, it will not increase the income earning capacity of the borrower and it will be difficult for him to repay the loan.

- Amount and Period of Loan : A bank cannot grant big loans to a few individuals or concerns. It has to meet the requirements of many persons. Similarly, a bank cannot grant loan for unduly long periods because a major portion of its deposits represents demand deposits which are repayable on demand, so the bank must consider the period of loan while examining the proposal from the borrower.

- Security Offered: The bank should also consider the nature of security offered for the advance. A bank should accept that type of security, which is easily marketable and stable in value. A bank should keep adequate margins in case of securities whose prices fluctuate widely. The bank should also verify that the borrower is the real owner of the security offered. The bank must take the possession of the security. The borrower must pledge the security, if it is movable, and mortgage it, if it is immovable, pledge or mortgage must be executed by way of legal documents as far as possible.

- Adequate Margin : A bank should not lend up to the full value of the security provided because its value may go down with the passage of time. It must keep a sufficient margin so that it does not suffer loss because of loss in its value due to depreciation or fall in its price when the borrower makes difficult in making the payment. The margin should also be sufficient to cover the cost of realizing the asset and the interest charges in case of default by the borrower. It is clear that if the loan is not paid regularly its outstanding balance go up, but the value of the collateral may go down due to depreciation and other reasons. Therefore, the gap between the loan amount and the value of its collateral must be enough to cover this uncertainty.

- Diversification : The advances of the banks must be spread over different regions, industries and sectors. The bank should not grant loan only to a few persons or concerns. If the advance portfolio of the bank is diversified, the bank

will not suffer heavy loss if a firm fails to repay the loan. So a bank should grant short and medium term loans to a number of persons and business organizations whose projects are sound and who offer sufficient security of tangible items. In other words, the bank should avoid keeping all eggs in one basket.

9.3 CONSIDERATIONS FOR SOUND LENDING :

The banker, before advancing loans to customers should take certain considerations. These considerations are related to the bank itself, the borrower and the project.

A) Consideration about the bank itself :

The banker should investigate his home regarding its liquidity, solvency and profitability, before advancing loans to customers.

- Liquidity : means the ability to meet deposit withdrawals and currency outflows and the availability of sufficient liquid asset.

  The banker is obliged to pay cash as customers demand withdrawals and to pay liabilities at maturity date. If the bank fail to fulfill currency outflow as demanded, due to lack of liquid cash (currency) the bank regulators will take an immediate action up to closure of the bank.

- Solvency : this is the state of the relationship between its assets and liabilities. When the value of the bank's total asset is greater than the value of the bank's total liability the bank is referred as solvent and when the value of the bank's total asset is less than the value of the bank's liability, the bank is referred as insolvent. In general, the banker's asset value should be solvent to be credit worthy. Otherwise, the banker will be liquidated, if creditors claim their balance. The greater the solvency of the banker, the greater its ability to advance loans to customers.

- Profitability : the main purpose of banking business to maximize profit and earnings/returns of shareholders in a form of dividends. Hence, bank loans are the main sources of bank profitability. However, as the bank advances loans, there are certain riskier conditions that may arise from: interest rate fluctuations (interest rate risk), borrowers default (credit risk) and liquidity problem by the bank (liquidity risk).

Therefore, as the banker try to maximize profit, it should at the same time stick the balance with these risks that could arise due to advancing loans.

B) Consideration about the Customer :

Banks do not advance loans to any one who demands credit. Not all applicants are genuine. There are people who apply for loan from the bank either without having a well studied project, or without having the required skill to manage the business or with some purpose other than stated in the application. Therefore, a banker before advancing loans to applicants, be has to evaluate and select the right applicant that can properly utilize the loan

amount and who can make more value / surplus / on the project. So as to do that the bank can appraise the following five C's about a customer.

- Character : here we can raise a number of questions that helps us to weigh the behavior of the applicant. For example, Is the customer dependable? Is the customer willing to repay the loan according to the contract? Is he willing to use the fund advanced for the right purpose that he applied for? Etc
- Capacity : the ability of the borrower to manage his business is a vital consideration made in advancing a loan. In order to measure his capacity to manage his business, we can see his educational level and type and his experience as an entrepreneur or as an employee.
- Capital : here we measure the financial soundness of the customer. If a customer covers majority of the project cost, it is believed that, he will be highly committed to the success of the business/project. The bank can measure not only his contribution to the project, but also his alternative sources of capital to repay the loan in the event of adverse circumstances?
- Credit Worthiness : is the customer honest? Can he be up to his contract? This can be derived either the customers past experience with the bank or the customer's relationship with other banks. Credit information is collected from other banks, too, for that effect.
- Collateral : The purpose of advancing loan is to enable the customer to undertake his business in a better standard and achieve a better value to himself – profit and to enable him to repay the loan within the agreed time period. However, things do not go always right as being expected to be. The business may get bankruptcy and the loan remain unpaid. Therefore, so as to secure the repayment of the loan the banker requires customers to provide adequate collateral/security for the loan. If the loan is not repaid as agreed up on the bank can sell/auction the property and use the proceed to cover the unpaid balance. It must be noted, however, that the purpose of the collateral for the banker is not to disbanded the owner with outright sale.

C) Consideration About the Proposal / Project :

Bank loans are not free gifts that can be used by the borrower as he wish, rather it must be used for the right purpose the loan is granted for in a regulated manner. Therefore, the banker while financing projects, it should consider certain paints about the project / proposal such as :

i. Purpose : The purpose of a project being financed by the bank should not be contradicting to the law of the nation. It must be legal. Besides, the project should be able to meet certain social benefits. It must contribute the efforts of eliminating certain social problems like poverty, unemployment, disease, famine, illiteracy, etc. Hence we can raise questions related with such issues as: Does the project socially viable? Does it contribute anything to the

community and the natural development? Does it create job opportunity to the community members? Etc

ii. Profitability/Viability : the profitability or viability of the business must be determined. It is wise to invest in projects that attracts positive net inflow than those with negative net-inflow. Therefore, before the bank permit loan to a customer, first the viability of the project must be studied. The projects viability can be measured through project appraisal or feasibility study.

Feasibility study is a detailed evaluation of a project to determine the technical feasibility, the economic necessity, financial viability of the project and managerial competence required for its successful operation. This might be done at two stages :

1st : by the promoter for identifying the right project.

2nd : by a banker or financial institution for the purpose of determining whether the project should be financed by it or not.

- Technical Feasibility: it is carried out to determine location of the project. This can be studied by observing suitability of the business area and by assuming the market share of the client.
- Technology used: it determines the skill required, nature of product, efficiency of the project, cost effectiveness etc.
- Plant and Equipment: it determines the suitability of the physical plant to accommodate the operation in the project.
- Construction and Installation Schedules: this helps to identify the required grace period in relation with the gestation period and to analyze the condition within which the business starts functioning.
- Economic Necessity : it is studied to measure the extent to which
    - the market will absorb the additional production on account of the new project
    - the project is expected to contribute to the national fund.
    - the project can bring about development in the area
    - the project will create more employment
    - the atmospheric and other pollutions could be contained.
- Financial Viability : A study is carried out to measure the financial viability of the project which may include :

- Cost of the project : The project must be viable in terms of its cost analysis. The return from investment must be greater than the investment amount. Therefore, the banker must see the relationship between the size and purpose of the loan before advancing the loan. If the amount required is more than the size and purpose of the loan, the bank must demand clarification from the customer. If the response is not satisfactory, the bank can decline the loan request so as to avoid future unnecessary

conflicts that could arise between the bank and the customer due to default in repayment by the customer.

- Source of finance : This is to determine how well or bad the business was managed in terms of finance. The promoter's contribution and other sources of finance should be investigated, if any. Therefore, the following ratio analysis should be carried out in this regard.

Debt – Equity Ratio = Total Debt / Net Worth

Profitability Ratio = Profit / Sales

Return on Capital Ratio = Profit / Capital

Liquidity Ratio (Or) Current Ratio = All Current Assets / Current Liabilities

Quick Ratio = Cash + Cash equipments + Receivables / Current Liabilities and others.

Managerial Competence: This is to determine the ability to run a business either in terms of education or experience or both.

iii. Sources of Repayment : It is to measure the source of funds used to repay the loan and we can ask questions regarding this issue as follows. Is the income from the project sufficient to cover the regular repayment? Is there any other source of repayment in case an adverse effect occurs to the project?

iv. Terms of Repayment: it is to determine as to when the loan will be paid in full and to determine the schedule for repayment. For example the repayment may be made every month. Quarterly or semi – annually, annually or at lump sum. This should be determined before the loan is advanced.

9.4 FACTORS LIMITING THE LEVEL OF ADVANCES :

The following are factors that limit the level of loans to be advanced to borrowers.

- **The type of deposits at the bank :** Banks may provide different alternative deposit accounts as it has been discussed in unit two of this course. It was also discussed that time and saving deposit accounts are relatively long-term than demand deposit accounts. Hence, amount deposited in savings and time deposits can be used for long term loans and those in demand deposit accounts are used for short-term loans. As such, the greater the savings and time deposits the banker has, the greater loan it will create and vice versa and the greater the demand deposit accounts the greater the short term loans the banker can make.

- **Credit control by the national bank:** national bank is the ultimate regulator of the financial and credit systems of a country through different controlling instruments such as required reserve, discount interest rate and open market operations and other methods. (Refer Money and Banking). The National Bank's financial/credit policy may be expansionary or contracting. If the National Banks Credit Policy is expansionary, the level of credit advanced by commercial banks will be higher than if the National Bank's credit policy is contradicting.

- **Seasonal variations:** the amount of credit advanced to borrowers is determined by the borrowers themselves. If the demand for loan is greater, the loan advanced will be higher and vice versa. The demand for loan also will depend upon seasonal factors such as: the busy season, the harvest time, the slack season, the festive season etc, that affects the business activities – business activities flourish during the busy season, the harvest time and the festive season and business need more money to run its operation at a higher level. Therefore, its demand for loans will also increase and vice versa.

9.5 Principles of Sound Lending and Investment :

We know that bank employs most of its resources in advancing money to commerce and industry and in buying the Government and other first class securities. A bank also invests some portion of its funds in discounting and purchasing commercial bills. While investing its funds in various assets, a bank is generally guided by the three cardinal principles: liquidity, profitability and safety or security. They will be discussed as follows.

a. Liquidity : by liquidity we mean the capacity of the bank to pay cash in exchange of deposits. According to Sayers, "Liquidity is the word which the banker uses to describe his ability to satisfy demand of cash in exchange of deposits." The position of the bank is liquid when it is able to pay cash to its depositors whenever demanded. It is advisable for a bank to maintain a sufficient degree of liquidity in its assets.

A large part of the deposits received by the bank is in the form of demand deposits which are withdraw able without any notice, i.e., on demand. So the bank must maintain sufficient amount of funds every time to meet the demand of the customers. If a bank keeps most of its funds in the form of cash, it will not earn any income because cash is an idle asset. Bank can invest the money in those assets which are highly liquid and which can be converted into cash without any loss of value. By doing so, the bank will be able to meet the demand of its depositors at all times and in addition, it will also earn some income.

The foundation of the entire banking structure in the country rests on the confidence that the banks are able to create in the minds of the people. People have confidence in a bank when they are sure that they will get back their deposits whenever they demand. So the bank must maintain sufficient cash reserves with it or should invest sufficient funds in near cash assts (i.e., which can be converted into cash at a short notice without any loss of value) so that it is able to meet the demands of its depositors. A bank can maintain liquidity in its assets when it employs funds in liquid assets. A liquid asset can be converted into cash quickly and

without any loss. A bank can pay its depositors in full only when its assets can be sold without loss. Therefore, a bank must be able to convert its assets into cash quickly and without loss. In short, the word liquidity has two attributes.

- ability to convert into cash quickly, and
- ability to convert into cash without any loss of value.

b. Solvency : It represents the state of affairs of the bank under which a bank is able to meet its debts obligations. A bank is said to be solvent when the value of its assets is more than (or at least equal to) the value of its liabilities. But a bank is said to maintain liquidity when its assets can be converted into cash quickly and without loss.

A bank may be solvent but may not be liquid. The implication of this fact is that the value of assets of the bank exceeds the value of the liabilities of the bank, but the bank has not employed its funds in liquid assets, which might be converted into cash quickly and without loss. Liquidity depends on shiftability without loss. It should not be sacrificed for higher profitability and excessive liquidity is also not necessary as it will influence profitability adversely.

c. Profitability : A bank is a commercial organization. One of the objectives of a bank is to earn sufficient profit. The bank must earn sufficient income from its assets so as to meet all its expenses and pay a fair percentage of dividend to the share holders. The bank employs its resources to earn income, to pay interest on deposits, to meet expenses of administration, to build up reserve fund and to pay dividend to shareholders. The profits of the bank will be higher if the yield from the assets is greater. The bank should determine the portfolio in such a way that it is able to derive maximum income. The bank should invest its funds in those securities, which give higher yields. But it should be noted that in order to earn higher yield, liquidity of the assets of the bank will have to be sacrificed.

Profitability and liquidity are too complicated considerations which must be reconciled by the bank. Liquidity can be obtained at the expense of profitability, i.e., as liquidity position of the bank increases, either idle asset (cash) or investment on low income securities increases. And profitability can be achieved at the expense of liquidity i.e., as the banker tries to increase its profitability, it has to increase loans and investments that has long duration and which yields higher income but are more riskier. These long term loans and investments attracts more returns but they cannot be easily. Without loss and in a short term convertible into liquid asset (cash). Besides these long term loans and investments beer higher risk such as credit risk, interest rate risk and finally liquidity risk.

A bank can secure perfect liquidity when it keeps all the deposits in cash. At this point, profitability will be zero because cash is an idle asset and does not fetch any income unless it is invested. But if a bank lends all the deposits to merchants and industrialists, it will earn high income at the cost of liquidity. It will not be able to pay the depositors whenever they demand. Because there is a constant conflict between the concepts of liquidity and profitability, the bank should always try to reconcile both the considerations. For this, a bank

should keep adequate cash reserves or near cash assets to meet the day-to-day requirements of the depositors and invest the balance in profit earning assets. So it must have some assets which are highly, liquid but less profitable and other assets which are highly profitable but less liquid. In such a case, the bank will have adequate cash to meet every demand or claim of the depositors and will also earn enough income to run the business and pay dividend to the shareholders.

The secret of successful banking is to distribute resources between various forms of assets in such a way as to get a sound balance between liquidity and profitability so that there is sufficient cash to meet the claims of the depositors and at the same time there is enough income from the assets to meet its expenses and distribute profits among the shareholders.

d. Security or safety : A bank deals in the money of the public. It receives deposits from the public and promises to repay the same along with interest at the predetermined rate. So a bank cannot afford to invest its funds in risky adventures even though it may earn high income from such investments. A bank is in the nature of the trustee of money belonging to public. It must ensure the safety of the funds of depositors. That is why most of the banks invest their funds in Government securities and do not prefer securities like shares and unsecured debentures. Though Government securities fetch less yield, yet they are highly secured.

The existence of a bank depends on the safety of its investments. So safety of funds should not be sacrificed to earn higher profits. If a bank neglects the consideration of security of funds, it will lead itself to a disaster. The bank will lose its funds because its borrowers may not repay the loan. In such a case, it will not be able to pay the depositors in full due to which confidence of the depositors in the banking system will be shaken. So a bank should be cautious in making investment in various assets. Caution is the essence of successful banking. Particularly while making loans and advances to customers the bank should be sure about their credit worthiness. It should also insist on sufficient security against loans and advances.

In general banks to be profitable while being safe, it has to establish a balanced portfolio. It must represent sufficient liquidity to meet the demands of the depositors and some portion of the funds should also be invested in those assets are highly profitable. While choosing the assets for investment, bank should not forget to see that it is a safe investment in the interest of the depositor and the bank itself. In Ethiopia, the banks are required to keep minimum cash reserves of 15%of time and saving deposit and 5% of demand liabilities. National Bank of Ethiopia has been empowered to regulate the required reserve ration that individual commercial bank can maintain. While determining the structure of assets or at the time of granting loans and advances, a bank should be guided by the three principles of sound investment, namely liquidity, profitability and safety.

9.6 TYPES OF SECURITIES :

The principle of safety has assumed great significance because a safety of assets of the bank is essential for the very survival of the bank itself. This is why, banks attach great importance to the security offered while advancing credit to their customers. A prudent

banker ensures that advances given to the business persons and the industrialists are backed by sufficient collateral securities. These securities must be tangible and easily marketable so that the bank may sell them to realize the debt in case of default by the borrower. The most important types of securities lodged with bank for securing advances are: goods, documents of title to goods, stock exchange securities, real estates, supply bills, life insurance policies and fixed deposits receipts

9.7 LOAN POLICY :

The restriction imposed by statutory law and administrative regulation does not provide answers to many questions regarding safe, sound and profitable bank lending. Questions regarding the size of the loan portfolios. Desirable maturities, and the types of loans to be made are left unanswered.

These question and many others about lending must be answered by each individual banks. Thus, it is desirable to have explicit lending policies to establish the direction and use of the funds from the stock holders, depositors, and others, to control the composition and size of loan portfolios, and to determine the general circumstances under which it is appropriate to make a loan. More and more banks have developed formal, written lending policies in recent years. The comptroller of the currency now insists that national banks have such policies. Although written lending policies serve a number of purposes, the most important is that they provide guidance for lending officers and thereby establish greater degrees of uniformity in lending practice.

Factors that Influence a Bank's Loan Policy :

Since lending is important for both the bank and the community it serves, loan policy must be worked out carefully after considering many factors. For the most part, these some factors determine the size and composition of the secondary reserve and the investment account of bank .

The most important factors that influence bank loan policy are :

- Capital position
- Risk and profitability of various types of loans
- Stability of deposits
- Economic conditions
- Influence of monetary and fiscal personnel
- Ability and experience of bank personnel
- Credit needs of the area to be served.

The capital of a bank serves as a cushion for the protection of the depositor's funds. The size of capital in relation to deposits influences the amount of risk that a bank can afford

to take. Banks with a relatively large capital structure can make loans of longer maturities and greater risk,

Since earnings are necessary for the successful operation of a bank, all banks consider this important factor in formulating loan policy. Some banks may emphasis earnings more than others. Banks, with a greater need for earnings, might adopt a more aggressive lending policy than those who do not consider earnings to be paramount. This aggressive policy might be making a collectively large amount of term or consumer loans, which normally are made at a higher rate of interest than short-term business loans.

A bank, in formulating its loan policy, must consider the fluctuation and type of deposits. After adequate provisions have been made for the primary and secondary reserves. Banks can then engage in lending. Even though these two reserves are designed to take care of the predictable deposit fluctuations and loan demand, unpredictable demands force banks to give consideration to the stability of deposits in formulating loan policy.

The economic conditions of the country as well as, to some extent, the world are influential in determining its loan policy. A stable economy is more conducive to liberal loan policy than one that is subject to seasonal and cyclical movements. Deposits of feast or famine economics fluctuate more violently than do deposits in an economy noted for its stability. A great consideration must be given to the national economy. Factors that adversely affect the nation as whole may, if they are of serious magnitude, eventually affect local conditions.

The lending ability of banks is also influenced by the monetary and fiscal policies. If additional reserves are made available to the commercial banking system, the lending ability of banks will increase. Under these conditions, banks can have a more liberal loan policy than if the opposite situation exists wherein expansion of bank reserves is being curbed or reduced.

The expertise of lending personnel is not insignificant in the process of formulating bank lank loan policy For example, officers may have considerable ability and experience in business lending but practically none in making real estate loans, while in other banks their specialty may be consumer lending. One of the probable reasons banks were slow in entering the consumer-lending field was the lack of skilled personnel same banks may be so specialized in certain fields of lending that their presence may influence the loan policy of other banks.

An obvious factor influencing commercial bank's policy is the area it serves. The major reason that banks are chartered (licensed) is to serve the credit need of their communities. If this cannot be done, there is little justification for their existence; Banks are morally bound to extend credit to borrowers who present logical and economically sound loan request. Banks in areas where the economy is predominantly one of cattle raising, for example, can not turn their back on this type of lending, but must tailor policy to fit the needs of this economic activity.

Items Included in a Loan Policy :

The items are included in loan policy and dealt properly as follows :

a. Loan territory :

The territory to be served by a bank must be defined will depend on many factors, including the amount of its resource, competition, the demand for loans and the bank's ability to supervise or keep in close contact with the borrowers .

Bank may have no territorial limitations for certain classes or loans. For example, very large banks make loans to large national business firms no matter where their principal offices may be located.

b. Types of loans to be made :

Bank management must decide what type of loans would be best for the bank. Some of the more important considerations in making this decision are the risks associated with various kinds of loans, the need for diversification to spread the risk, the need for liquidity , the types of customers the bank wants to serve, the capabilities of bank personnel, and certainly, the relative profitability of various kinds of loans. To the extent that it is practicable, banks diversify their loan portfolio among the various broad categories of loans such as business, consumer, real estate and agricultural and strive also for considerable diversification within each of these broad categories.

c. Acceptable Security and credit worthiness :

To facilitate lending, reduce risks, and maintain standard practices, a bank's loan policy should deal with the question of what is considered acceptable security and credit worthiness. If certain loans are to be secured, the lending officers should have some indication of what is acceptable security. For example, some banks may not want to accept account receivable as security or household goods for consumer loans. Further more, a bank may disapprove accepting consumer loans that are endorsed by the borrower's friends or relatives. Banks may not wish to make real estate loans on single-purpose buildings. Construction loans may be made only in cases where the work is being supervised by a competent architect and the contractor has provided a completion bond and acceptable security. Banks may not want to lend more than a certain period of the fair market value of the securities. Some collateral may not be acceptable at all. Such as cars over five years old, or highly perishable commodities. Banks may wish to limit the amount of individual consumer loans to a certain percentage of borrower's annual disposable income. For acceptable collateral, an indication should be given as to the amount of funds that will be advanced on such security.

Banks may receive requests for loans from applicants who do not have acceptable credit worthiness. To save the time of the credit department and lending officers, it is advisable to outline what is considered acceptable. Consumer loans might be restricted to persons who are presently employed and have been for a minimum period, and who have an assured income and a satisfactory credit record. Loans to businessman may be restricted to

those who have been in business for a certain length of time and have demonstrated an ability to produce a commodity or render a service profitably.

d. Maturity :

A comprehensive loan policy would certainly cover loan maturity. The maturity of a bank's loan portfolio will affect bank liquidity as well as its risk exposure. Term loans to business are apt to be less liquid than 30-60-or 90- day business loans, and the 20-year real estate loan lacks the liquidity of one made for a period of ten years. As loan maturities increase, money and credit risk also have a tendency to increase, some banks may not wish to make loans on real estate for exceptionally long periods and some may not want to make many business loans on a term basis. Moreover, some banks may wish to limit loans for the purchase of automobiles to 24 or 30 months rather than longer periods. To serve as a guide for the loan officer, the policy regarding maturities should be definite.

e. Excess lines :

One problem confronting many banks is that of loan requests exceeding their legal lending limit. The applicant may be a customer of the bank who is entitled to the credit requested, and the loan would be satisfactory from the standpoint of security and maturity. The bank is then faced with the choice of either working out a satisfactory arrangement with a correspondent bank to carry the excess portion of the loan, or refusing the request and running the risk of losing the applicant's account, which may be valued highly. Some banks may not handle such requests or even lend up to their limit. Others may have a policy of arranging for a correspondent bank to carry the excess loan. These days, such loans are becoming more frequent than in the past necessitating to carry the excess loan. These days, such loans are becoming more frequent than in the past necessitating pulling funds by a member banks. Such loan is termed as syndicate loan.

f. Loan Commitments :

Many bank customers, especially large business borrowers plan their borrowing needs with the bank in advance of the time the funds will be actually needed Therefore, banks adopt a policy regarding the types of commitments that will be made, the types of enterprises to which they will be made, the amounts that will be made available, and the charge for such commitments. Such planning is of value to the bank in that it gives some indication as to the demand for credit during certain periods of the year and plans can be made regarding the maturity of other loans.

A commitment is an agreement, oral or written, between a bank and a borrower whereby the bank stands ready to extend an agreed amount of credit for a specified period of time. A commitment may have no restriction attached or may be subject to a member of conditions such as security, fixed-asset limitations, officer's salary limitations etc. Normally, loan commitments do not exceed one year and may take several forms. Probably the simplest form is an oral commitment that a certain amount of credit will be available at a certain time in the future. Many loan commitments take this informal arrangement and are frequently

referred to as open lines of credit. Its not uncommon for such a statement to be in written form, however.

An even more formal commitment would be what is commonly referred to as a stand by commitment. A stand by commitment is usually a more binding and exacting financial arrangement that is a line of credit. The bank and the borrower enter into a formal contract in which the bank agrees to lend a certain amount to the borrower and the borrower enter into a formal contract in which the bank agrees to lend a certain amount to the borrower and the borrower agrees to borrow. The agreement includes a statement regarding the time the funds will be available and such lending terms as security and interest rate of the loan. The borrower pays a fee for this commitment that is usually based on the Un- borrowed amount of the commitment.

A revolving credit is usually of longer maturity than is a line of credit. If firmly obligated the bank to lend a certain amount to a borrower for a stated period. The terms of the agreement are written out in detail since the agreement usually runs from one to three or more years. Under a revolving credit the borrower agrees to borrower for a stated period. Under a revolving credit the borrower agrees to borrow in accordance with the terms set forth and to pay a fee that is computed on the un- borrowed portion of the established maximum. A revolving credit agreement can become quite detailed and can include such items as the use of the borrowed funds, the rate of interest the maturity of the notes, submission of financial statements and other financial and a production data, security and, in case of default, provisions regarding termination of the parchment and repayment of the loans outstanding .

g. Loan Pricing :

The pricing of bank loans involves the setting of interest rates and in some cases, the imposition of loan fees. Interest rates may be either fixed or variable. As the term implies, a fixed rate is one that remains the same during the loan contract. A variable rate is one that may change during the term of the loan the prime rate the rate banks charge their most creditworthy business customers-is the most popular variable rate and varies with changes in money market conditions. Banks may also make loans. The interest of which is tied to the prime rate. A loan might be made at a rate of one or two full percentage points above the prime rate. For example as the prime rate increases or decreased. The reason for this type of arrangement is the belief on the part of both borrower and bankers that is more equitable than negotiated rates especially in an environment characterized by considerable amount of inflation. Loan fees are sometimes imposed, depending on the amount of work involved in making a loan; these are found especially in the granting of term loans and in real estate lending.

The numerous factors that are considered in pricing loans include :

- The cost of funds
- The degree of risk in the loan
- The maturity of the loan

- The costs of originating and administering the loan (these costs, as a percentage of the loan, are a function of the size of the loan, the amount of credit investigation required, the cost of acquiring and maintaining control of the collateral , and the expense of collecting the loan.)
- Rates available to the borrower from competitive sources of funds, including other banks and the commercial paper and bond markets
- The overall relationship between the bank and the borrower (this included income earned on the borrower's deposit balances as well as paying cheques and collecting deposited items for the borrower.)
- The rates of return that can be earned on alternative investments.

h. Administration of the Loan Policy :

After the loan policy of a bank has been formulated, provision of its proper execution must be made. Certain individuals must carry out the loan policy, and some provisions should be made for its periodic review and evaluation in order to make any necessary changes. It should be remembered that a loan policy serves as a guide to lending not as a straightjacket Economic conditions change and so should a loan policy. Periodically, the loan portfolio and lending practices should be compared with the loan policy to determine whether it is being followed and if changes should by made.

The person in charge of the overall lending organization should be in charge of supervising the bank's loan policy. In small banks this may be the manager or of the deputy managers. In banks that rely to a great extent on loan, a loan committee will be given a responsibility to supervise lending; this body would be responsible for effecting the lending policy of the bank. In larger banks the responsibility would probably be assigned to the senior deputy manager in charge of lending , who would explain the provisions of the loan policy to the lending officers and secure their cooperation in carrying it out, which is necessary for a loan policy to be successful. Lending officers cannot consider what is desirable to them; they must consider what is good for the bank. The purpose of a lending policy is to promote the objectives of the lending function, not to serve as an end within itself .

9.8 ORGANIZATION OF BANK LENDING :

The organization of the lending function depends on numerous factors, including the character and quality of the lending officer, the size of the bank, the size of the loan portfolio, the types of loans to be made, and the board of director's attitude towards the amount of authority delegated. The legal responsibility for bank lending rests with the board of directors, and some boards play a more important role in lending than do others. In general, large banks delegate lending authority and specialize in lending more than do smaller ones.

The lending officer usually makes personal contact with the borrower, receives application for loans, interview the applicants, decide whether the applications are worthy of consideration, and may obtain all the necessary information about the applicant, or part of it

may be obtained by the credit department. The lending officer may make the decision to grant the loan request, or this may rest with a committee or the board of directors, depending on the size of the request. Once the loan has been made, he/she usually supervise the loan: that is, keeps in close contact with the borrower during the life of the loan. This may include plant visits, occasional visits with the borrower in the bank and requests for financial and other credit information from the borrower and from other sources. In the event of difficulty with the loan, the lending officer will exert every effort to collect the amounts outstanding. If renewals or additional funds are requested, he/ she handle these requests, as per the given conditions.

In small unit banks, all the officers may perform lending functions along with their other activities. Each officer may handle all types, of loan requests, whether they are for consumer, business, or real estate purposes. Little formal specialization prevails however; one officer may specialize in some types or type of loans because of special interest or experience. Each officer must secure the necessary credit information and maintain the credit files, since few small banks have a separate credit department. Each officer may have a lending limit within which decisions can be made regarding loan requests. Loans, above a certain amount, may be submitted to a loan or discount committee, which will make the decision or, in smaller banks refer the request to the board of directors for further consideration if the loan is extremely large or in any way unusual. In medium – size unit banks. There is more delegation, of authority and specialization regarding lending. Many medium- size banks have credit departments. Each officer may have an established lending limit, which is usually higher than in small bank. Sometimes a loan committee composed of senior loan officers may exist within the bank to handle loan requests above the lending officer's limit. Members of the board of directors may be in this committee. I this is the case, only those requests requiring special attention would be referred to the discount committees and the board of directors. As in the small banks, supervision of the loans would be the responsibility of the lending officers.

The lending organization in large unit banks differs considerably from that in mall banks and to some degree, in medium –size banks, in the departmentalization and specialization of lending activities. Large banks may have such lending departments as real estate, business or commercial, consumer and agricultural some of these departments are broken down further. Business loans, for example, can be divided according to industry. With a lending officer in charge of each industry or related industries. One large bank, for example, has separate loan divisions for iron and steel, automobiles, machinery, agricultural implements, electrical products, radio and manufacturing sundries (products). Many banks also divide their lending activities on territorial basis.

Lending officers in large banks have lending limits, limits, but they are usually higher than those in medium and smaller banks. Larger banks make greater use of officer loan committees than do small- and medium-size banks. They may be organized on a formal or informal basis according to departments. For example, a request for a real estate loan larger than the lending officer's established limit would be referred to an officer's loan committee

composed of real estate lending officer, rather than officers from several departments. With an organization of that kind, only the very large requests are referred to a loan or discount committee, and probably few, if any requests are referred to the board of directors for action.

In larger banks, the credit department plays a much more important role in the lending process than it does in smaller banks. The lending officer turns over to the credit department all the information received from the applicant that would be used in the preparation of a formal loan request.

Additional credit information on the applicant would be secured from many sources and assembled in one folder for the use of the lending officer, who in turn may discuss it with some colleagues or the officers loan committee . The report of the credit department may include, such items as financial statements (with balance sheets and profit and loss statements for a period of years arranged on one sheet so they can be evaluated at a glance) various financial statement ratios that have been calculated by the credit department, credit agency reports, pictures of the applicant's place of business, budgets, analysis of the industry's prospects as well as the applicant's and many other details of value in making a decision on whether to grant the credit request.

The lending organization in branch banks varies considerably. Branch managers and officers may have limited loan authority. Just as in a unit ban, loan requests above this limit might be referred to the head office where consideration would be given to the request by the regional supervisor of that particular branch and a decision reached. The regional supervisor may also have a lending limit. Loans exceeding this limit would be referred to a loan or discount committee.

From a practical standpoint, it is not desirable to have a great deal of centralization of lending authority in the head office. Borrowers do not like to wait for credit decisions, and much of the personal touch important in credit evaluation, is lost if many request to be directed to the head office. When there are many branches, the head office usually performs general policy supervision and permits branch managers' considerable discretion in lending. This, in fact, is about the only way branches can be operated efficiently.

9.9 FOLLOW – UP AND SUPERVISION :

Bankers appraise the loan applications carefully with the idea of eliminating such borrowers who may fail to keep their promises by not repaying the loans or diverting money to inappropriate uses. But an appraisal alone can never guarantee protection against such a type of future risk. In any business, forecasting future performance on the basis of present plans and conditions and past performance is subject to wild errors. These errors may take place as the future is full of uncertainties and many changes may occur in various fields, for example, economic conditions, management capabilities, technology, consumer taste, motivation, etc. In order to take care of these changes and thus, protect oneself against such

future risks, post – allocation supervision or follow – up becomes imperative. It should be kept in mind by bankers that the loan left to itself is lost, unless properly followed up.

The Process of Supervision :

Before discussing the supervision of advances, it should be clear that controls are required not because the bank doubts the honesty and integrity of the borrower but for reason that they guard themselves against any fraud , misappropriation and also not allow an honest client to become dishonest.

In fact, supervision or follow – up starts from the point where appraisal ends, that is from the stage of disbursing the loan. At the time of disbursal, the banks should carefully supervise the end – use of money. Often the money is diverted for purposes other than stated in the loan application, thus defeating the basic objectives of providing finance. Very often, over-financing (that is more than the requirements) also gives rise to problems like diversion of funds, capitalization of funds for non-productive purposes, trading on a much larger scale beyond the capacity and entering into speculative business. Thus, the foremost requirement for an effective follow-up is that the party's requirement should be assessed exactly and finance equivalent to these needs should only by provided .

The Technique of Supervision :

There is general acceptance among bankers of the desirability of having a provision of supervision of the bank credit. Each bank, by its experience, should design the supervision or follow – up forms in such a way that all relevant and critical information is collected avoiding an unnecessary and unmanageable store of information.

The small industrial units, in general, have very little resistance power against odds and require intensive care by the bank, even after providing the finance. Normally, supervision is not liked by any one; but the entrepreneurs may not resent supervision if they are convinced that it is in their interest and shall also mean the continuance of financial assistance. Most of the entrepreneurs, who are carrying out the entire gamut of industrial activity single-handed, shall welcome technical or managerial help and guidance. The advice will be definitely heeded for them, when it comes from the people who provide the major share of funds to them. But such advice presupposes a good rapport between the banker and the borrower. In facts, at no time the banker should leave an impression that the is there to act as a 'policeman' whose job to trace culprits and book them, rather he should be like a family doctor who comes to the enterprise with the intention of curing ills.

Thus, it would not be wrong to say that what the small borrower need is 'counsel' than 'cash'. This fact is further reinforced by Arthur Lewis remark that Lending money to inexperienced small business people without the drain. What these people need is first supervision and advice and only secondarily capital – And when money is lent, its use should be supervised carefully , the officers of the institution should have powers to enforce changes in managerial practice as a prior condition of the loan and to check unprofitable practices at least until the loan has been paid.

It can be summarized that the main objective of follow- up is to act as a radar indicating how the wind blows so that the signs of developing difficulties could be detected in time and thus minimize the number of sick units, if not able to completely eliminate them.

9.10 SUMMARY :

Modern Banks are loan providers. Loans are money or purchasing power given today for future repayment. It is postponement of today's consumption to the future by the creditor and the consumption of future income today by the borrower.

Banks offer different types of loans which are classified using different criteria. In order to guide the lending activity banks develop loan policies. A policy is a general guideline that directs decisions made by members of a certain company. It gives the boundaries within which decisions are to be made. Therefore, individuals and groups can have the authority to make their own decisions with n the boundaries of the policy. Hence, the quality of decisions made depends not only on the quality of decision makers, but also the quality of the policy designed. Likewise, loan policy developed by bankers gives guidance to the bank members as to what decision are to be made at different times and conditions. This helps, decision makers in particular and the bank in general, to maintain uniformity of activities and decisions.

9.11 KEY WORDS :

Loans And Advances :

The term loan refers to money borrowed by one entity from another, repayable after a defined period and carrying an interest rate.

Withdrawn :

Removing funds from a bank account, savings plan, pension, or trust.

Overdraft :

An excess amount of money that is withdrawn from an account as compared to the amount deposited and that results in a negative account balance.

Industrial Loans :

Any type of loan made to a business or corporation and not to an individual.

Medical Loans :

A form of personal loan that you can avail of in the event of a medical emergency.

Clean Loans :

A type of loan that does not have any conditions attached to it.

Credit Worthiness :

A measure of how likely you will default on your debt obligations according to a lender's assessment, or how worthy you are to receive new credit.

Adequate Margin :

Collateral having such value as is adequate, under the Margin Rules and in accordance with the internal policies of Broker, to secure the Secured Obligations.

Diversification :

The practice of spreading your investments around so that your exposure to any one type of asset is limited.

Viability :

A commercial judgement of the ability of a business to meet ongoing financial obligations, with an additional margin of comfort to support future investment and trading.

9.12 SELF SUGGESTED QUESTIONS :

1. Reasons for dishonor of Cheque
2. How to avoid dishonor of cheque?
3. What are the consequences for dishonouring the cheque?

9.13 SUGGESTED BOOKS :

1. Bhole, L.M., Financial Institutions and Markets, 4th ed., Tata McGraw Hills, New Delhi, 2004.
2. Bank Financial Management, Indian Institute of Banking and Finance, Taxman's Publications, July 2004.

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LESSON – 10
ADVANCING LOANS AGAINST SECURITIES

Objectives :

After reading this lesson, one should be able to

- Understand Advancing Loans against Securities;
- Understand the advance against documents of title to goods; land & buildings / real estate
- Know about Life insurance policy; bank receipt

Structure of the Lesson :

10.1 Precautions to be taken while Advancing Loans against Securities

10.2 Advance against documents of title to goods

10.2.1 Meaning

10.2.2 Essential requirements of a document of Title to Goods

10.2.3 Risk in Advance against document of Title to goods

10.2.4 Precautions to be taken by the banker at the time of Advancing against the documents of title to goods

10.2.5 Documents of Title to Goods (Bill of Lading, Warehouse keeper's certificate, Dock – warrant, Railway Receipt, Delivery Order etc)

10.3 Advance against land & buildings / real estate

10.4 Advance against Insurance policy

10.5 Bank receipt

10.6 Summary

10.7 Key Words

10.8 Self Assessment Questions

10.9 Suggested Books

10.1 PRECAUTIONS TO BE TAKEN WHILE ADVANCING LOANS AGAINST SECURITIES :

On granting advances certain precautions are necessary

Purpose of the loan :

The repayment mostly depends upon the purpose for which the loan is obtained. To a borrower who is engaged in speculation, the chances of loss are greater. As such the loss will have to be shared by the banker. So, advances should not be allowed for speculative purposes.

The integrity of the borrower :

The banker should ascertain that the borrower is trustworthy, honest and a man of sufficient experience in his business. Such a precaution is necessary to avoid fraudulent dealings. For example, when a customer offers 100 bags of paddy, as security it is impossible to inspect each and every bag. He has to rely on the honesty of the borrower.

Further, he should see whether the borrower has experience in adequate practical his business. An experienced businessman is conversant with risks and the profitable areas of the business. An inexperienced one may incur a loss and be a potential risk.

Nature of the commodity :

The banker should have a working knowledge of some of the special features of the commodities offered as security. The commodities which could be disposed of easily, the quality of goods which are not subject to deterioration and price of goods which are almost steady should be preferred by a banker as security.

Knowledge of different markets :

A banker should be conversant with the markets for different commodities. This is essential to regulate the margin for the goods according to the price
prevailing in the market. Failure to have knowledge of the market will put him at the mercy of the borrower who may inflate the value to get more advances.

Ascertain the title of owner :

Before accepting goods as security, the banker should ascertain the title of the borrower to the goods by inspection of the original invoice or cash memos.

Proper storage :

The banker should select go downs which are pucca built and safe in every way for the storage of goods. The roof and flooring should be situated near the bank so that the bank's representative can have direct and free access to them at any time. All goods stored in bags or bales should be so arranged as to facilitate inspection easily. A careful selection should be made of go down keeper and watchmen. They should be honest and possess a high sense of responsibility.

Creation of charge by Pledge and Hypothecation :

A banker may create a charge over the goods either by pledge or hypothecation. In the pledge, the goods or title thereto is delivered to the banker. In hypothecation, neither possession nor goods are transferred to the banker. So, a written undertaking from the borrower should be obtained that the goods are not charged to any bank and will not be charged till the agreement continues with the bank.

Rented go down :

If the borrower makes use of a rented go down, the bank must obtain an undertaking from the owner of the building stating that the bank has a prior lien. This is necessary because at times the building owner may have a prior claim for rent due and the position of the banker will be at stake.

Insurance up to the full market value :

Goods should be insured against all known risks up to their full market value. The relative insurance policies should be held by the bank.

10.2 ADVANCE AGAINST DOCUMENTS OF TITLE TO GOODS :

10.2.1 Meaning :

Section 2 (4) of the sale of Goods Act defines a Document of title to goods as "A document used in the ordinary course of business as a proof of possession or control of goods authorizing or purporting to authorize either by endorsement or delivery, the possessor of the documents to transfer or to receive the goods thereby represented."

10.2.2 Essential requirements of a Document of Title to Goods :

- The mere possession of the document creates a right by law or trade or usage, to possess the goods represented by the Document.
- Goods represented by documents are transferrable by endorsement and/or delivery of the document. The transferee can take the delivery of the goods in his own right.
- Bill of Lading, Dock – warrant, Warehouse – keeper certificate, Railway receipt and delivery orders, etc. can be said as the documents of title to goods.

10.2.3 Risk in Advance against Document of Title to goods :

1. Possibility of Fraud Dishonesty :

- It may happen that the documents may be forged one or the quantity written within the documents may be fraudulently altered.
- The shipping and railway authorities too do not testify such documents, they only testify the number of bags or packages received for the purpose of transportation.

2. Not Negotiable Document :

These documents are not negotiable instruments like cheque, bill of exchange and promissory note.

- Here banker cannot have better title, if the documents are forged or stolen one.

3. Forgery of Endorsement :

- "Forgery conveys no title", therefore, in case of forged endorsement banker cannot assert his right of ownership.

4. **Right of stoppage in transit is with the unpaid seller :**

- If the buyer becomes insolvent before the goods are delivered to him, the unpaid seller can stop the goods in transit.

10.2.4 Precautions to be taken by the banker at the time of Advancing against the documents of title to goods :

1. **Integrity of the customer :** In order to avoid risk of fraud the banker should take into account the character, capacity and capital of the customer. Banker should only accept the documents as security from honest, reliable and trustworthy customers.

2. **Certificate of Packing :** Banker should always ask for the certificate to ascertain the content of the packages or bags.

3. **Supervise the Packing :** the banker should depute a representative to supervise the packing.

4. **No Onerous Condition :** If the document of the title to goods contains any onerous remark, it make it unfit to be a security. The banker should avoid to advance against such documents.

5. **Endorsement in Blank :** The banker should get the document endorsed in blank, or the liability to pat the freights will be on the part of banker and not of the customers.

6. **Insurance against Risk :** The goods must be insured against the risks like Fire and theft for its full value. The banker should ask for the insurance policy before granting advances against such documents.

7. **Special care in realizing the goods :** It is advisable on the part of the banker, not to part with the security before repayment of advances.

8. **Other Precautions :**

   - Proper examination to ensure the originality and recent origin of the document.
   - Insurer must be a reliable person or firm for the goods in the document.
   - To obtain a general stamped letter for the purpose of Hypothecation.

10.2.5 Documents of Title to Goods :

1. **Bill of Lading :**

Meaning : "A document issued by the shipping company acknowledging the receipt of goods to be transported 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."

Contents / Items in Bill of Lading :

1. Names of Consignor and consignee
2. Names of the ports of departure and destination
3. Name of Vessel
4. Date of departure and arrival
5. List of goods being transferred
6. Number of packages and kind of packaging
7. Marks and numbers on packages.
8. Weight of the goods
9. Freight and amount
10. Description of goods

Features of Bill of Lading :

1. It carries full ownership of the goods with it. The person presenting the copy of Bill of Lading can have the delivery of the goods.
2. It is issued by the shipping company. It is a contract of affreightment.
3. It is not a negotiable instrument but it possesses some characteristics of negotiability and so it is quasi negotiable instrument.
4. It is transferable by mere endorsement and delivery.
5. It contains all details of the goods to be shipped.

The delivery of the bill od lading or endorsement of the bill of lading will be considered as Symbolic Delivery of the goods.

Functions of Bill of Lading :

1. Evidence of receipt of goods.
2. Evidence of contract of carriage.
3. Documentation of title to goods. (proof of ownership)
4. It can be used in the transaction of letter of credit and can be quasi negotiable.
5. It can be bought, sold, traded and can be used as securities too.

6. It can be used as evidence in case of controversy regarding ownership of the goods.

Precautions in case of Bill of Lading :

1. At the time of granting advances against Bill of Lading, the banker should ask for all the copies of it, as it is prepared in triplicate, the customer can acquire the possession by showing any of the copy to the ship master.
2. It is advisable to get the document endorsed in blank, or the banker will be liable to pay the freight charges on the goods.
3. The banker should verify that the freight charges are paid by the consignee. The captain of the ship will have the right of lien over the goods when there is non payment of freights and other charges.
4. It should be taken care of that the insurance policy having the cover of all the marine perils must be accompanied in the bill of lading.
5. The origin and the genuineness of the bill of landing should be examined carefully before advancing against it.

2. Warehouse keeper's certificate (wharfinger's Certificate) or warehouse Certificate :

Meaning :

- "Warehouse receipt means an acknowledgement in writing or in electronic form issued by the warehouse keeper or by his duly authorized representative."
- Warehouse means a store where goods are accepted temporarily for safe keeping. On the receipt of the goods a warehouse keeper gives a certificate known as warehouse keeper's certificate.
- Under the Bombay Warehouse Act 1959, the warehouse receipt shall be transferable by endorsement.

Elements of Warehouse Receipt :

1. Serial number
2. Name of warehouse and its location license number.
3. Date of issue of receipt and duration of storage..
4. Name of commodity, its quantity, quality and grading.
5. Private mark of depositors on goods.
6. Rate of storage and other charges, if any.

7. Approximate value of goods stored.
8. Insurance details.
9. Whether warehouse receipt is negotiable on non negotiable.
10. Signature of warehouse keeper or his authorized agent.

Features of warehouse certificate :

1. It is a document to title to goods. (Sale of Goods Act, 1930)
2. Issued by warehouse keeper.
3. Written or printed.
4. States the ownership of goods.
5. It is a deposit receipt and non transferable or transferable based on circumstances.

Precautions in the case of warehouse receipt :

1. The banker should verify the title of the holder or transferor.
2. No advance should be granted against the warehouse receipt issued by unlicensed warehouse.
3. Verifying the genuineness of the receipt and to check the signature of the warehouse keeper.
4. Banker should satisfy himself about the condition of the goods at warehouse by inspecting the warehouse.
5. The banker should ask for a disclaimer regarding the ownership of the goods at the prescribed warehouse.
6. The advance should be given according to the memorandum of pledge.
7. The banker inform the warehouse keeper about the lien of the receipt by him.
8. Banker should also see that the goods at the warehouse are insured at all time and the rent and other charges are paid by the customer.
9. Banker should inform the warehouse keeper not to release the goods without the consent of the banker.
10. The certificate should also be accompanied with the delivery order.

3. Dock – warrant :

Meaning :

"A Dock- Warrant is the document issued by a dock company in exchange of goods received."

Key points of Dock – warrant :

1. The document possesses title to goods and the person named in can obtain the possession of the goods stored at the dock.
2. It is not a receipt, but it is a warranty only.
3. It can be transferred by endorsement and delivery.

Precautions in the case of Dock –Warrant :

1. Before advancing against the dock-warrant, the banker must be satisfied with the integrity and the financial condition of the customer.
2. It is to be verified that the dock company is having the authority of lien on goods or not.
3. To prevent the unauthorized dealing of the goods, the banker should get himself registered as owner of the goods.

4. Railway Receipt :

It is a document issued by the Railway authority acknowledging the receipt of the goods for the purpose of transportation to a space specified therein.

It cannot be transferred by endorsement and delivery.

Precautions to be taken by the banker in case of Railway Receipt :

1. Documentary bill of well established parties only should be accepted / discounted.
2. To examine the authenticity of the railway receipt, banker should examine it carefully.
3. The railway receipt should be endorsed in favour of bank. (bank should be made a consignee by endorsement)
4. There should not be any alteration in the receipt other than the competent authority.
5. The goods must be covered by the insurance against fire, theft and damage in transit.
6. The banker should accept only "Freight Paid" railway receipt, as banker would ot be paying any freight due.

7. To ensure the validity and the availability of the goods the date of the receipt should be checked carefully.

8. Advance should not be granted in case if the receipt contains the information regarding the damaged goods or defective packing.

5. Delivery Order :

- Delivery order is an order issued by the owner of the goods to the warehouse keeper to deliver the goods to a particular person.

- According to the Uniform Commercial Code, "A delivery order refers to an order given by an owner of a goods to a person in possession of the warehouse keeper directing that person to deliver the goods to a person named in the order."

- It is the document issued by the transporter or the carrier of the goods directly if they have their own office at the destination. The holder of the delivery order must either take delivery of the goods or obtain a receipt or warrant from warehouse keeper or get his title of goods registered in the books of the warehouse keeper.

Precaution in case of Delivery Order :

1. Before accepting the delivery order as security, the banker should check the authenticity of both the parties, customer offering the document and the company issuing the order.

2. The banker should also check that the delivery order is issued for the same goods that are stored in the warehouse.

3. The banker should also verify that the order contains the name of the pledger.

4. In order to avoid risk, the banker should register the delivery order with warehouse keeper.

5. Special care has to be taken as the delivery order should not remain outstanding for long period of time.

10.3 LAND & BUILDING / REAL ESTATE :

It is common security accepted by the banks. During the lending bank mortgaged/creation of charged the landed property in favour of the bank. The advantage of these types of securities is that their value generally increases over time. It is fixed and cannot be shifted to another place. It can be freehold or leasehold property. Valuation of the property is required for acceptance as a security in the loan account. The advantages and disadvantages of this form of security cannot be universally applied to all lands and it

depends on the nature of the land offered. We shall now discuss both the advantages and disadvantages.

ADVANTAGES :

The advantage of collateral security of Land & Building are as under :

(i) The advantage that land has over other types of securities is that its value generally increases with time. With every fall in the value of money, the value of land goes up, and due to its scant availability in developing areas, its value is bound to increase.

(ii) It cannot be shifted, a fact which sometimes is also a disadvantage.

(iii) The securitisation of the mortgaged property can be done without court intervention under SARFAESI Act 2002.

DISADVANTAGES :

The disadvantage of collateral security of Land & Building are as under :

(i) Valuation is at times difficult :

The value of a building depends on several factors such as location, size of property, amenities, etc., this makes the valuation very difficult. Buildings and the materials used in the buildings are not alike. Buildings must be valued on a conservative basis because of the limited market in the event of a sale.

(ii) Ascertaining the Title of the Owner :

The banker cannot obtain a proper title unless the borrower himself has title to the property to be mortgaged. In India, the laws of succession particularly those relating to Hindus and Muslims being very complicated, it is difficult to ascertain whether a person has a perfect title to the property or not. Title verification must also be done to know whether the property was encumbered. Bank's advocate has to be done by verifying records with the Registrar's office, which involves expense and time. In the case of agricultural land, with the introduction of land ceiling legislation, legislation protecting the tenants' rights, absence of up-to-date and proper land records, it has become less valuable as security.

(iii) Difficult to Realize the Security :

Land is not easily and quickly realizable, due to the lack of a ready market. It may take months to sell and sometimes if the market is not favourable, it may fetch a lower price than what was anticipated. After the SARFAESI Act 2002, now the bank can securitize the mortgaged property without the intervention of the court.

(iv) Creating a Charge is Costly :

The security can be charged either by way of a legal mortgage or by way of an equitable mortgage. An equitable mortgage may be created by a simple deposit of title deeds with or without a memorandum. Since the remedies under a legal mortgage are better than those under an equitable mortgage. However, completing a legal mortgage involves expenses including stamp duty and a lot of formalities.

Precautions to be taken by the banker :

Before an immovable property is accepted as security, the banker should take the following precautions.

(i) Borrower's Title :

The banker should get a penal advocate report to verify the title to the property and the right of the borrower to a mortgage. Advocate has to certify that the person in whose property stands has a good, valid, subsisting, and marketable title over the property, that the property is free from all encumbrances, and is not subject to any litigation or attachment from any court or statutory authorities.

(ii) Enquiry Regarding Prior Charges :

The borrower should produce a certificate from the Registrar's office listing the charges over the property over some time (generally 30 years) that the property is free from encumbrances. This is commonly understood as a non-encumbrance certificate. If any prior charges exist the banker's right will be subject to such prior charges.

(iii) Freehold or Leasehold :

A freeholder is the absolute owner of his land and can deal with it as he likes. A leasehold property is one, which is taken on lease for a period and a leaseholder derives a legal status for a term of years from the freeholder and is free to deal with the land when acting within the terms of the lease and the law during that period. When the lease expires, the land reverts to the freeholder. In the case of leasehold property, the unexpired period of the lease is an important consideration. The longer the unexpired period of the lease, the greater is the value of the security. The bank should also ensure that there are no onerous covenants such as the necessity of taking the freeholder's consent before mortgaging the property. The banker should also obtain the last ground receipt to ensure that the lease is active.

(iv) Valuation Property:

The Valuation of the property is necessary to consider as collateral security. Valuation should be done by bank-approved valuers who would be engineers or architects. The valuation report must be comprehensive, realistic and based on the following points.

a) The location and size of the property

b) Area of the land and building

c) The nature and cost of construction

d) Age of the building, Present status and future life

e) Tax and other obligations

(v) Documentations :

The mortgage deed must be drafted carefully considering all the legal stipulations. It should be witnessed by at least two persons In the case of a simple mortgage it attracts ad-valorem stamp duty.

(vi) Verification of Tax Receipts :

The banker should request the borrower to produce late the st tax receipts since any arrears of tax constitute a preferential charge on the property.

(vii) Insurance of The Property :

To avoid loss of security by fire, natural calamities, it is prudent that in the case of buildings the banker insists on the insurance of the property for its full value at the borrower's expense.

10.4 LIFE INSURANCE POLICY :

A life insurance policy is generally taken for both financial security and saving purposes. The assignment of the policy in favour of the banker requires very few formalities and the banker obtains a perfect title. The policy is tangible security and in the custody of the bank. The security can be realised immediately the borrower's on default of payment by surrendering the policy to the insurance company. In the event of the borrower's death, the debt is easily liquidated from the proceeds of the policy.

ADVANTAGES :

- Life insurance business being highly regulated and permitted only to companies having sound financial health, the banker need not doubt the realisation of the policies, which will be done without any difficulty, if the policy and the claim are in order.
- The assignment of the policy in favour of the banker requires very little formalities and the banker obtains a perfect title.
- The longer the period for which the policy has been in force, the greater the surrender value. It is also useful as additional security because, in the event of the borrower's death, the debt is easily liquidated from the proceeds of the policy.
- The security can be realized immediately on the borrower's default of payment by surrendering the policy to the insurance company.

The policy is tangible security and is in the custody of the bank. The banker only has to ensure that regular payment of premiums is made.

DISADVANTAGES :

If the premium is not paid regularly, the policy lapses and reviving the policy is complicated. Insurance contracts being contracts of utmost good faith, any misrepresentation or non – disclosure of any particulars by the assured would make the policy void and enable the insurer to avoid the contract.

- The person (proposer) who has obtained the policy must have an insurable interest in the life of the assured or the contract is void.
- The policy may contain special clauses, which may restrict the liability of the insurer.
- When the banker accepts a policy coming under Married Women Property Act he must ensure that all the parties sign in the bank's form of assignment.
- There is a facility to obtain the duplicate policy if the original is lost. This can be misused by persons by obtaining duplicate policies. The banker should, therefore, verify that no duplicate policy has been issued and there are no encumbrances on the policy.

Precautions to be taken by the banker :

- The policy must be assigned in favour of the bank and should be sent insurance directly to company the for registration and ensured that only the authorized office of the Insurance Company has noted the assignment.
- The bank should see that the age of the assured is admitted.
- The banker should ensure the regular payment of the premium.

10.5 WHAT IS A BANK RECEIPT?

Banks handle large amounts of money. It’s what they were designed to do. As such, they need ways of keeping track of transactions. Most banks have a number of different documents that help with recordkeeping. An example of this would be a bank deposit slip. It records information regarding a bank deposit. Like the bank deposit slip, banks also provide receipts to their customers.

Bank receipts are offered to customers any time a transaction takes place. They record important information regarding transactions between the customer and the bank. They are given to customers as proof of the transaction taking place. Banks encourage customers to keep their copies of bank receipts for recordkeeping purposes. A few types of banking transactions that receipts would be provided for are listed below:

- Bank deposits, including cash deposits or check deposits
- Transfers to or from accounts
- Cash withdrawals
- Electronic funds transfers or wire transfers
- Loan payments
- Credit card payments

Banks are responsible for providing receipts regarding any financial transaction. It is the customer's responsibility to keep the receipt for their records.

What Information Can You Find on a Bank Receipt?

When you look at your bank receipts, you'll see that they provide a large amount of information. This information pertains to the transaction in question. Generally, a new receipt will be issued for each transaction that takes place. The information you'll find on a bank receipt will contain most, if not all, of the following information :

- The name of the account holder
- The banking account number
- The type of transaction (deposit, withdrawal, transfer, etc.)
- The amount of the transaction
- The time and date of the transaction
- The name of the bank employee who assisted you

Most bank receipts look similar to typical receipts. Where receipts from a bank can be for a number of transaction types, regular receipts are only for payments. They'll be similar to bank receipts, but they always display things relating to a payment. An example of this would be the date and time of payment for goods and services.

Why Should I Keep My Bank Receipts?

There are a number of reasons that bank receipts should be held onto. It doesn't matter if you're banking personally or for business purposes, receipts should be kept.

Keeping Personal Bank Receipts :

Keeping receipts for personal banking purposes has a variety of benefits. It allows you to track your finances more closely. It also allows you to keep proof of the transaction that took place. This can help you resolve any disputes should any money be missing from an account.

Banks also encourage customers to balance their finances at least once a month using stored receipts. This includes receipts for payments, as well as bank transactions. This is the best way of staying on top of your personal finances.

Keeping Business Bank Receipts :

Any business owner will tell you that keeping bank receipts is critical. It allows for better bookkeeping. It also provides a means for disputes should large amounts of money go missing. The problem with keeping physical receipts as a business owner is how quickly they pile up. Companies do a lot of dealing with banks, and that can lead to a lot of bank slips. Thanks to technology, though, there are plenty of tools that can be used to assist in this process.

Most major accounting software programs will let you scan or photograph receipts for digital storage. The best software options will automate the accounting process, as well. They have artificial intelligence built-in that can read the text on the documents. Once the information is scanned it is entered into the bookkeeping portion of the software.

Receipts for businesses are also a way of tracking business operations. Many times, deposits for small businesses are made after hours using a bank deposit box. Keeping the deposit slip and the receipt ensures that the employee made the deposit appropriately.

10.6 SUMMARY :

Modern Banks are loan and advances providers .on providing advances certain precautions are necessary. They are providing advances against documents of title to goods as A document used in the ordinary course of business as a proof of possession. And provide advances against land and buildings/real estates and also provide life insurance policy is generally taken for both financial security and saving purposes.

Banks handle large amounts of money. It's what they were designed to do. Bank receipts are offered to customers any time a transaction takes place. They record important information regarding transactions between the customer and the bank.

10.7 KEY WORDS :

Deterioration :

Any naturally occurring process or a natural disaster that results in the destruction or partial destruction of a public document.

Hypothecation :

Occurs when an asset is pledged as collateral to secure a loan.

Documents :

A document is a record of some information that can be used as an authority or for reference, further analyses or study.

Dishonesty :

Whoever does anything with the intention of causing wrongful gain to one person or wrongful loss to another person.

Forgery :

Making of a false writing with an intent to defraud.

Integrity :

The quality of being honest and having strong moral and ethical principles.

Endorsement :

A signature or an equivalent stamp that authorizes payment or a transfer of funds, or other financial transaction.

Insurer :

The party in an insurance contract that promises to pay compensation.

Consignor :

The person who delivers goods to the consignee for sale.

10.8 SELF ASSESSMENT QUESTIONS :

1. Write about loans against securities.
2. Discuss advance against documents of title to goods.
3. Discuss advance against land & buildings / real estate.
4. Explain advance against insurance policy.
5. what is bank receipt?

10.9 SUGGESTED BOOKS:

1. Banking law and practice, Kalkundrikar, kembhavi, Nataraj – Himalaya Publishing House.
2. Control of Commercial Banks in India, Dr. Mohammad Quddus.

A.S. Kalyani

LESSION – 11

CLAYTON RULE AND GARNISHEE ORDER

Objectives :

After Learning reading this lesson, one should be able to

- understand the concept of clayton rule;
- know about the garnishee order

Structure of the Lesson :

11.1 Clayton Rule

- 11.1.1 Introduction
- 11.1.2 Case Background
- 11.1.3 Clayton Rule in the Indian Context
- 11.1.4 Right to Appropriation
- 11.1.5 Types of Loan Accounts

11.2 Garnishee Order

- 11.2.1 Application of the Garnishee Order to Various types of Account
- 11.2.2 How a Garnishee Order works
- 11.2.3 Features of the Garnishee Order

11.3 Attachment Orders

- 11.3.1 Attachment Order is different from Garnishee Order in following respects

11.4 The stages and procedure involved in Garnishee Proceedings

11.5 Summary

11.6 Key Words

11.7 Self Assessment Questions

11.8 Suggested Books

11.1 CLAYTON RULE :

11.1.1 What is Clayton's Rule?

Clayton's rule is based on the maxim "Quicquid solvitur, secundum modum solventis" meaning whatever is paid, is paid according to the intention or manner of the party making payment. Therefore, when the debtor makes a payment, they may direct how the money should be appropriated, and the creditor has no right to alter it without the debtor's consent. It was first laid down under the Devaynes Vs. Noble case.

As per Clayton's Rule, each withdrawal made in a cash credit account is considered a new loan, and each deposit made to repay the loan will be applied in the order of the loan taken.

In simple words, the first debit in the account will be discharged by the first credit deposited, and likewise, other entries will be released in chronological order. Hence, it is also called the first-in, first-out principle. In India, this rule is applicable based on the Indian Contract Act, 1872. However, now bankers close the operation of accounts in case of insolvency or death of a partner / joint account holder / guarantor.

Devaynes Vs. Noble (1816) 35 ER 781 :

In this case, Mr Clayton had an account with a partnership banking firm named Devaynes, Dawes, Nobel, and Co. One of the partners, named William Devaynes, died. The amount due to Mr Clayton was £1,717. After that, the surviving partners paid more than the said amount to Mr Clayton. Later, Mr Clayton also further deposited with the firm. The banking firm had gone bankrupt. Mr Clayton had also claimed the money.

The learned Judge Sir William Grant, Master of the Roll, held that the deceased partner's estate would not be liable to Mr Clayton. The payment that the surviving partner made was more than the amount due and would be considered as a discharge of liability of the firm at the time of death of a partner.

Business, banking, trade and monetary transactions have been the life blood of any civilization. Man has been engaged in trade and financial business since time immemorial.

However, certain times, difficult and confusing situations arises as to the distribution of assets and liabilities within a group of co-owners and in that case, certain laws have been made to ensure free and fair share of everyone's rights and responsibilities to the funds and liabilities without fear, favour, affection or ill-will of any person.

The Clayton rule is a common law in relation to the distribution of assets in the form of money from a bank account. This rule was made as part of the judgement of the Devaynes vs. Noble case of 1816. The judgement was taken as a president and a common law known as Clayton's rule was put into effect for further cases of such nature.

11.1.2 Case background :

The famous case dates to 1816 when Mr. Clayton had an account with a banking form which was a partnership named Devaynes, Dawes, Noble, and Co. One of the partners William Devaynes died. The amount then due to Clayton was £1717. The living partners remaining there after paid out to mystically 10 more than the amount while Clayton himself on his part made for the deposits with the firm. The firm subsequently went bankrupt.

According to the judgement it was concluded that whatever period is paid or is to be applied according to the mode laid down by the payer. Therefore according to this when a debtor makes a payment, appropriation of the fund can be done to any of the debt that he pleases. And the creditors must be agreeing to it.

11.1.3 Clayton rule in the Indian context :

In the Indian constitution the Clayton rule has been incorporated by the provision of the Indian contracts act 1872. Appropriation of payments and the rules relating to it made by the debtor who owes a number of distinct dates to his creditor are present in sections 59 to 61 of the Indian Contract Act 1872.

In order to further delve into the Indian Contract Act we need to first know the meaning of appropriation of funds. Appropriation of funds refers to the allocation of money for a particular purpose. Sometimes when there are multiple transactions we do not know which payment has been sent against which purchase. In order to clear out this confusion the Clayton's rule is applied.

There are few distinct cases which call for different situations and applications of the law :

Appropriation in order of receipts and payments – the rule of Clayton's law is applicable when the two parties have an account that owns no interest. In that case appropriation takes place in the order in which the receipts and payments take place and are carried into the account. Thus as per the rule unless there is contrary intention the items on the credit of an account must be appropriated against the items on the debit in order of date.

When the debtor does not intimate and creditor fails to appropriate – According to section 61, if the debtor does not expressly intimate and where the creditor fails to make any appropriation, the payment shall be applied in discharge of the debt in chronological order. If the debts are of equal standing, the payment shall be applied in discharge of each proportionately.

Where the debtor intimates – According to section 59:

(i) Appropriation of payment is a right primarily of the debtor and for his benefit. If the debtor expressly intimates at the time of actual payment that the payment must be applied towards the discharge of a particular debt, the creditor must do so.

(ii) If there is no express intimation by the debtor, the Law will look to the circumstances attending on the payment for appropriation. There is an established maxim that when money is paid, it is to be applied according to the express will of the payer, not to the receiver.

When the debtor does not intimate and the circumstances are not indicative (Sec.60) :

(i) When the debtor does not expressly intimate or where the circumstances attending on the payment do not indicate any intention, the creditor may apply his own discretion to any lawful debt actually due and payable to him from the debtor.

(ii) The creditor may also, until he has declared appropriation to the debtor, alter the appropriation.

(iii) He cannot, however, apply the payment to a disputed and unlawful debt, but he may apply it to a debt, which a barred by the law of limitation.

Part – payment is applied for the interest first and for the principal afterwards –

Regarding part – payment, the general principle, subject to any contract to the contrary, is that the payment should first be applied to the interest and after the interest is fully paid off, to the principal.

Whenever the borrower repays loans to lender, the interest amount will be satisfied first and then will eat satisfy the principal amount. Also these rules do not come into effect unless there are multiple transactions between the lender and the borrower.

That means number of monetary transactions have to be done in different period of time. Appropriation of payment does not apply to single transactions.

The rule is only a presumption, and can be displaced. Notwithstanding the criticisms sometimes leveled against it, and despite its antiquity, the rule is commonly applied in relation to tracing claims where a fraudster has commingled unlawfully obtained funds from various sources.

Exception

The rule does not apply to payments made by a fiduciary out of an account which contains a mixture of trust funds and the fiduciary's personal money. In such a case, if the trustee misappropriates any moneys belonging to the trust, the first amount so withdrawn by him will not be allocated to the discharge of his funds held on trust but towards the discharge of his own personal deposits, even if such deposits were, in fact made later in order of time.

The court had laid down the following rules –

a) Where the debtor owes the creditor, the debtor has the right to appropriate the payment to discharge any debts.

b) If the debtor at the time of payment does not expressly or impliedly directs the appropriation of payment, then the creditor has the right to appropriate the payment.

c) If the debtor or creditor fails to indicate any appropriation of payment, then appropriation is made as per law, according to the entries made in the account. The first entry on the debit side is the entry discharged or reduced by the first entry on the credit side.

11.1.4 What is the right to appropriation?

Appropriation means the application of payments.

Clayton's rule's applicability in India is based on Section 59-61 of the Indian Contract Act, 1872, which lays down the principle for applying the payment to a particular debt.

Appropriation by the debtor – Application of payment where debt to be discharged is indicated – section 59

If a debtor owes several debts to one person, make payment to him, express or implied, under certain circumstances indicating that the payment should be applied to discharge a particular debt. Therefore, the payment received should be applied accordingly. Under this principle, the right of appropriation is given to the debtor. Once the appropriation is made, it cannot be reversed.

- Example : A owes B several debts, of which he owes Rs 4000 upon a promissory note to be paid on 1st August. A pays B Rs. 4000. Now, there is only one debt of that amount. Therefore, the payment will be applied to the discharge of the promissory note.

Appropriation by creditor – Application of payment where debt to be discharged is not indicated – section 60.

If the debtor owes several debts and fails to intimate or indicate which debt has to adjust with the payment made while paying his debts. Then, the creditor has the discretion to apply the payment to any lawful debt that is due and payable by the debtor, irrespective of whether any suit of limitation bars the recovery. Under this principle, the right to appropriation is given to the creditor.

- Suppose Mr. A has four loan accounts in a bank. He gives the banker Rs. 1Lakh to be deposited in his account but did not indicate which version he wanted the amount to be deposited. In the absence of any direction given by A, the banker deposits the said amount in account No.3. Later, A insisted that the amount should be deposited in account No. 1. As per the principle, the creditor has the right to use its discretion to deposit the amount in the absence of any direction given by the creditor.

In State of Gujarat Vs. Bank of Baroda, 1997, the debtor fails to indicate which loan he wants to appropriate the payment while making payment to the bank. The court had held that the appropriation by the bank was held to be proper under section 60.

Appropriation by law – Application of payment where neither party appropriates – section 61

If the person has more than one loan account, neither party (debtor or creditor) makes an appropriation; the payment will be used to discharge the debts in order of the time they were made. Suppose the debtor has debts of equal standing or value. In that case, the payment should be applied to the setting of each debt proportionately. Any payment that the debtor makes will be first applied to clear the interest and later towards the principal amount unless it is agreed to the contrary.

This section can be broken down into three parts to grasp it more clearly –

i. Payment will be discharged in order of the time they were made means –

- If X owes three loans to Y, namely – Rs. 1000 taken on 1st July, Rs. 500 taken on 20th July, and Rs. 1,500 taken on 1st August. Suppose X pays Rs 2000 without stating where to apply for the payment. In that case, the payment shall be appropriated to the first and second loans, and the remaining amount (Rs, 500) will be used towards the third loan.

ii. The money the bank receives will be used to set off against the interest. We can understand this with the help of an example –

- Suppose a person has Rs 1000 as the principal amount (initial debit entry) having an interest amount of Rs 100 when the debtor deposits a credit entry of Rs 500. Then, the bank will adjust the interest amount from the credit entry, and the debt will be appropriated accordingly. Therefore, 500 – 100 = 400. Rs 400 will be used against the principal amount (Rs 1000).

iii. Setting of each debt proportionately can be understood clearly with the given example

- X has two loan accounts, and both accounts have an equal number of dues, let's suppose, Rs 10,000 each. X makes a credit entry of Rs. 5000, and the interest rate is Rs. 100. So, 5000 – 100 = 4900. Then in such a case, both accounts will be adjusted equally, i.e., Rs 2450 each.

However, suppose the person has only one loan account, and such person regularly deposits and withdraws money from it. In that case, the order to set off credit entry against debit entry is in chronological order. Then, in such a situation, the first-in, first-out (FIFO) principle will apply, which is called Clayton's rule.

11.1.5 Clayton's rule applies to which types of loan accounts :

Clayton's rule applies to current accounts like cash credit and overdraft (OD) accounts or limit accounts, based on the First in-First out principle. This means the first debit entry will be adjusted with the first credit entry.

How is Clayton's rule applied?

A Cash Credit (CC) account customer is given the power to withdraw even if there is no credit in his account.

If G has a CC account and is given a 1Lakh DP limit;

Date	Transaction	Debit (Rs)	Credit (Rs)	Balance (Rs)
1/8/2022	Cheque withdrawal	1000	-	1000
5/8/2022	Cash withdrawal	2000	-	1000+2000=3000
8/8/2022	Cash withdrawal	500	-	3000+500=3500
10/8/2022	NEFT	-	500	

Here, from the 500 Credit entry, the first withdrawal of Rs 1000 will be adjusted. Hence, Clayton's rule of the first in-first out principle will be applied.

Let us take another example :

If XYZ partnership firm is given a DP/ CC limit of 1Lakh.

Date	Transaction	Debit (Rs)	Credit (Rs)	Balance (Rs)
1/3/2022	NEFT	30000	-	30,000
4/3/2022	Cash by X	45,000	-	30,000+45,000=75,000
5/3/2022 Mr X died	Cash by Y&Z	-	37,500	37,500

ABC bank goes for recovery from XYZ firm. Now, the question arises as to who has the liability to pay the amount. All the partners have the liability to pay the bank. The total to be paid is 75,000. So, 75,000 divide by 3 = 25,000 each. Here, X died, and the remaining partners deposited Rs. 37,500. This credit amount would be used to set off the first debit according to the FIFO principle. The balance amount of Rs. 37500 was left to be paid. The balance amount of 37,500 would be divided among 3 to discharge debts per the Clayton rule.

Conclusion :

Clayton's rule deals with appropriation of payment for discharge of debts. Under the Indian Contract Act, the debtor has the right to appropriate the payment in case there is more than one debt due to the creditor. The debtor making payment has the right to direct the creditor to appropriate the payment to discharge his debts. If the debtor fails to direct the creditor, then the creditor has the right to appropriate the debt payment. If the debtor and creditor fail to direct the appropriation of payment, then the appropriation can be made by law. Clayton's rule is based on the first-in, first-out principle, where the first credit entry made is used to discharge the first debit entry.

11.2 GARNISHEE ORDER :

A Garnishee Order is an order issued by court under provisions of Order 21, Rule 46 of the Code of Civil Procedure, 1908. The concept of 'Garnishment' has been introduced in civil procedure code by the amendment Act, 1976 and is a remarkable piece of legislation. This term has been derived from the French word 'garnir' which means to warn or to prepare.

In simple words the garnishee is the person who is liable to pay a debt to a debt to judgment debtor or to deliver any movable property to him. Besides Judgment Debtor and decree Holder, Garnishee is a third person in whose hands debt of the judgment debtor is kept.

Garnishee Order is an order passed by an executing court directing or ordering a garnishee not to pay money to judgment debtor since the latter is indebted to the garnisher

(decree holder). It is an Order of the court to attach money or Goods belonging to the judgment debtor in the hands of a third person.

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 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 the creditor from recovering the debt and the debtor from the 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 from the account concerned after the receipt of the Garnishee Order. The creditor at whose request the order is issued is called the judgement- creditor, the debtor whose money is frozen is called judgement- debtor and the banker who is the debtor of the judgement debtor 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 judgement- 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 the judgement- 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 financial order, called Order Absolute where the entire balance in the account or a specified amount is attached to be handed over to the judgement- creditor. On receipt of such an order to the banker is bound to pay the garnished funds to the judgement- creditor. Thereafter, the banker liabilities towards his customer are discharged to that extent. The suspended account may be revived after payment has been made to the judgement-creditor as per the directions of the Court. The following points are to be noted in this connection :

II. The amount attached by the order. A garnishee order may attach either the amount of the judgement debtor with the banker irrespective of the amount which the judgement- debtor owes to the creditor or a specified amount only which is sufficient to meet the creditor' claim from the judgement-debtor. In the first case, the entire in the account of the customer in the bank is garnished or attached and if banker pays any amount out of the same which is in excess of the amount of the debt of the creditor plus cost of the legal proceedings, he will render himself liable for such payment. For example, the entire to the credit of X, the principal debtor, ` 10,000 is attached by the Court while the debt owed by him to his creditor Y is only ` 6,000. If the banker honours the cheque of the customer X to the extent of ` 5,000 and thus reducing the balance to ` 5,000 he will be liable for defying the order of the Court. On the other hand, if he dishonours all cheques, subsequent to the receipt of the Garnishee Order, he will not be liable to the customer for dishonouring his cheques.

It is to be noted that the Garnishee Order does not apply to the amount of the cheque marked by a bank as a good for payment because the banker undertakes upon himself the liability to pay the amount of the cheque. On the other hand, if the judgement debtor gives to

the bank a notice to withdraw, it does not amount withdrawal, but merely his intention to withdraw. The Garnishee Order will be applicable to such funds. In the second case, only the amount specified in the order is attached and the amount is excess of that may be paid to the customer by the banker.

For example, X is customer of SBI and his current account shows a credit balance of ` 10,000. He is indebted to Y for ` 5,000. the latter applies to the Court for the issue of a Garnishee Order specifies the amount (` 5,000) which is being attached, the banker will be justified in making payment after this amount, i.e., the balance in the customer's account should not be reduced below ` 5,000. Usually in such cases, the attached amount is transferred to a suspense account and the account of the customer is permitted to be operated upon with the remaining balance.

III. The order of the Court restrains the banker from paying the debts due or accruing due. The word '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 utilized portion of cash credit or overdraft facility cannot be said to be an amount due from the bank of its customer. The above decision was given by the Karnataka High Court in Canara Bank vs. Regional Provident Fund Commissioner. In his case the Regional Provident Fund Commissioner wanted to recover the arrears of provident fund contribution from the defaulters' bankers out of the utilized portion of the cash credit facility. Rejecting this claim, the High Court held that the bank cannot be termed as a Garnishee of such unutilized portion of cash credit, as the banker's position is that of creditor. For example, PNB allows it as customer to overdraw to the extent of ` 5,000. The customer has actually drawn (` 3,000) cannot be attached by a Garnishee Order as this is not a debt due from the banker. It merely indicates the extent to which the customer may be the debtor of the bank.

The banker, of course, has the right to set off any debt owed by the customer before the amount to which the Garnishee Order applies is determined. But it is essential that debt due from the customer is actual and not merely contingent. For example, if there is an unsecured loan account in the name of the judgement-debtor with a balance of ` 5,000 at the time of receipt of Garnishee Order, such account can be set off against the credit balance in the other account. But if the debt due from the judgement- debtor is not actual, i.e., has not actually become due, but is merely contingent, such set off is not permissible. For example, if A, the judgement- debtor, has discounted a bill of exchange with the bank, there is contingent liability of A towards the bank, if the acceptor does not honour the bill on the due date. Similarly, if A has guaranteed a loan taken from the bank by B, his liability as surety does not arise until and unless B actually makes default in repaying the amount of the loan.

The banker is also entitled to combine two accounts in the name of the customer in the same right. If one account shows a debit balance and the other a credit one, net balance is arrived at by deducting the former from the latter.

IV. The Garnishee Order attachés 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:

(a) 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. In such cases, the banker acts as the agent for the customer for the collection of the cheques or for the sale of the securities and the amounts in respect of the same are not debts due by the banker to the customer, until they are actually received by the banker and credited to the customer's account. But if the amount of such uncleared cheque, etc., is credited to the customer's account, the position of the banker changes and the garnishee order is applicable to the amount of such uncleared cheques. Similarly, if one branch of a bank sends its customer's cheque for realization to its another branch and the latter collects the same from the paying banker before the receipt of the Garnishee Order by the first branch, the amount so realized shall also be subject to Garnishee Order, even though the required advice about realization of cheque is received after the receipt of the Garnishee Order. Giving this judgement in Gerald C.S. Lobo vs. Canara Bank (1997) 71 Comp. Cases 290, the Karnataka high Court held that the branch which collects money on behalf of another branch is to be treated as agent of the latter and consequently the moment a cheque sent for collection by the other branch has been realized by the former, the realization must be treated as having accrued to the principal branch.

(b) 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. Bankers usually open a new account on the name of customer for such purpose.

(c) The Garnishee Order is not effective in 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 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 the 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.

(d) In case of cheques presented to the paying banker through the clearing house, the effectiveness of the Garnishee Order depends upon the fact whether time for returning the dishonoured cheques to the collecting banker has 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 over, the

payment is deemed to have been made by the paying banker and the order shall not be applicable to such amount.

(e) **The Garnishee Order is not applicable to :**

- (i) Money held abroad by the judgement- debtor ; and
- (ii) Securities held in the safe custody of the banker,

(f) 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 intimation, the banker will not be held responsible for such payment.

11.2.1 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 judgement –debtor, the joint account cannot be attached. But, if both or all the joint account- holders are joint judgement- debtors in any legal proceedings, the joint account can be attached. For example, if A owes a debt of ` 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 judgement-holders, their individuals 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 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 partners is both joint and several. But the reverse is not possible. If a partner is a judgement-debtor, only his individual account may be attached and not that of the firm or those of other partners.

(c) Trust Accounts:

A trustee hold the funds or property of some 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 account and instruct the Trustee.

11.2.2 How a garnishee order works?

A default judgement is usually obtained by a creditor either when a debt has gone

unpaid, you haven't been able to come to any agreement with the creditor about repaying the debt, or other alternative debt collection avenues have been exhausted. If a garnishee order is made against you, then your bank, financial institution, or employer will likely be notified rather than you.

The payment made by the garnishee into the court pursuant to the notice shall be treated as a valid discharge to him as against the judgment debtor. The court may direct that such amount may be paid to the decree holder towards the satisfaction of the decree and costs of the execution.

11.2.3 Features of the Garnishee Order :

The bank upon whom the order is served is called Garnishee. The depositor who owes money to another person is called judgement debtor. Features of the Garnishee Order are as under;

- Garnishee Order applies to existing debts as also debts accruing due i.e. SB/CD, RD / FD Accounts.
- Garnishee Order applies only to those accounts of Judgement Debtor which have credit balance.
- The relationship between bank and judgement debtor is of debtor and creditor. Bank is the debtor of Judgement Debtor who is a creditor of the bank.
- Garnishee Order does not apply to money deposited subsequent to receipt of Garnishee Order. It also does not apply to cheques sent for collection but yet to be realized. But if credit was allowed in the account before realization with power to withdraw to customer, Garnishee order will be applicable on this amount.
- Garnishee Order does not apply to unutilized portion of overdraft or cash credit account of the borrower as no debt is due to judgement debtor. For example, if limit is Rs 4 crore and outstanding is debit Rs 3 crore, Garnishee order is not applicable on the balance Rs 1 crore.
- Bank can exercise right of set off before applying Garnishee Order.
- Garnishee Order is applicable only if both debts are in same right and same capacity.
- Garnishee Order issued in a single name does not apply to accounts in the joint names of judgement debtor with another person(s). But if Garnishee Order is issued in joint names, it will apply to individual accounts also of the same debtors. When Garnishee Order is in the name of a partner it will not apply to partnership account but when Garnishee Order is in the name of firm, accounts of individual partners are covered.

- If amount is not specified in the order, then it will be applicable on the entire balance in the account. However, if it is for specific amount, the cheques can be paid from the balance available after setting aside the amount as mentioned in the Garnishee Order.
- Not applicable on fixed deposits taken as security for some loan.
- If loan given against fixed deposits, applicable on the amount after adjusting the loan.
- Where neither the garnishee makes the payment into the court, as ordered, nor appears and shows any cause in answer to the notice, the court may order the garnishee to comply with such notice as if such order were a decree against him. The costs of the garnishee proceedings are at the discretion of the court. Orders passed in garnishee proceedings are appealable as Decrees.

11.3 ATTACHMENT ORDERS :

Income Tax Authorities Issue Attachment Orders in terms of Section 226(3) of Income Tax Act, 1961. On receipt of this order, banker is required to remit the desired amount to income tax authorities. An Attachment Order without mentioning the amount is not a valid order.

Attachment Order is different from Garnishee order in following respects :

- Attachment order applies to money deposited in the account after receipt of order also till it is fully satisfied whereas Garnishee order does not apply to subsequent deposits.
- Attachment Order in single name applies to joint accounts also proportionately unless the contrary is proved whereas Garnishee order in single name does not apply to joint accounts. However, right of set off is available to bank before applying the order.

In case banker fails to comply with Attachment Order, it will be liable for the amount of order and deemed as an assesses in default.

When both Garnishee Order and Attachment Order are received simultaneously, priority should be given to Attachment Order.

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COMPARISON OF GARNISHEE ORDER & ATTACHMENT ORDER

Particulars	Garnishee Order	Attachment Order
Issuing Authority	Competent Court of Law	Income Tax Department
Under which Act	Order 21, Rule 46 of the Code of Civil Procedure, 1908	Section 226(3) of Income Tax Act, 1961
Depositor called	Judgement debtor	Assessee
Bank called	Judgement debtor's debtor	Assessee debtor
Issued to recover	Recover of Private Due	Recover of Statutory due
Amount	May be mentioned specifically	Mentioned clearly in the Order
Applicable to (Amount)	On clear balance available with the garnishes at time of receipt of order	Amount in the account at the time of receiving order and future credit also attachable
Applicable to (account)	All demand deposit and Time deposit account	All demand deposit and Time deposit account
Right of set off	Available for lawful and due debts	Available for lawful and due debts
Joint accounts, order single name	Not Applicable	Applicable pro-rata basis.
Order in Partnership's name and account in partner's name	Applicable	Applicable
Joint account, order same joint names	Applicable	Applicable
Order in name of partner,	Not applicable for accounts	Not applicable for accounts

trustee, executor, liquidator, director of a company, etc	in name of firm, trust, company i.e. accounts in fiduciary capacity etc	in name of firm, trust, company i.e. accounts in fiduciary capacity etc.
Order in name of partnership/ company.	Individual Account of partner/ director is attachable.	Individual Account of partner/ director is attachable.
Deceased	Applicable.	Applicable
Insolvent	Not applicable	Not applicable
Undrawn CC or DD limit	Not applicable	Not applicable
FDR as collateral security	Not applicable	Not applicable
Failure to comply the order	Contempt of court	Assessee in default
Preference of Order, if received simultaneously or is pending for payment.	Attachment order will have the preference over Garnishee Order. However, bankers right of set-off is superior.	Attachment order will have the preference over Garnishee Order. However, bankers right of set-off is superior.

11.4 THE STAGES AND PROCEDURE INVOLVED IN GARNISHEE PROCEEDINGS :

The Garnishee Proceedings is sui generis[3], it comprises mainly of two stages which will be thoroughly explained below;

Stage One

To commence the Proceedings, Order 37 Rule 2 of the Federal High Court (Civil Procedure) Rules 2019 provides that the Garnishor must file a motion ex-parte, supported with an affidavit and a written address. At this stage, the court makes a garnished order nisi. The effect of an order nisi is to obviate the Garnishee (third party) from paying the Debtor's money in his possession to the Debtor; but to pay it directly to the Garnishor. The order nisi also compels the Garnishee to appear in Court on a specified date, for the sole purpose of showing cause on why he (the Garnishee) should not be mandated to pay the Garnishor the money owed to the Debtor. The order nisi is served on the judgment debtor and Garnishee 14days before the adjourned date for hearing. Section 83 Sheriffs and Civil Processes Act 2004, empowers the court to make an order for the attachment of the money in the custody of a third party belonging to a judgment debtor for the satisfaction of debt upon an application brought by a judgment creditor.

Stage Two

At this stage, the Garnishee comes to show cause. If he doesn't show good cause or fails to appear, the court will make the garnishee order absolute. This amounts to a final judgment and the Judge becomes funtus officio. It is apposite to state here that, where the Garnishee fails to pay; despite an order absolute, judgment will be executed upon him by writ of Fifa.

PROCEDURE

By the virtue of Section 83 (1) & (2) of Sheriffs and Civil Processes Act (SCPA), the proceedings is commenced by an application brought by a motion ex-parte supported with an affidavit praying for a Garnishee order Nisi. The affidavit in support of the motion ex-parte is in Form 25 in the 1st Schedule to SCPA and the affidavit must contain the following;

a) The names, addresses and occupations the judgment creditor, judgment debtor and Garnishee.

b) That the judgment had been given and the date.

c) That the judgment is still unsatisfied.

d) The amount of the judgment debt that remains unpaid.

e) That another person is indebted to the judgment debtor and is within state.

Failure to serve the Garnishee and Judgment Debtor the order nisi, will automatically amount to the nullification of the proceedings. If the Garnishee refuses to pay the said sum for reasons known to him, the Garnishee must go to Court on a date (not less than fourteen days after service) fixed for hearing by the Registrar, to refute the intention of the Court to make the order, absolute. The Garnishee does this by filing an Affidavit to Show Cause, which must contain any of the following facts;

- That the money does not belong to the Judgment Debtor.
- That the money belongs to a third party with a lien or charge over it.

He can also file a counter affidavit, showing reasons why the money in his possession should not be used to satisfy the debt.

As uncomplicated as the Garnishee Proceedings may be, there are two main contentious or diverging issues surrounding this proceedings and it is expedient to discuss them briefly.

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A. WHO ARE THE PARTIES IN GARNISHEE PROCEEDINGS?

As earlier stated, the parties in a Garnishee Proceedings are the Judgment Creditor (Garnishor), the Judgment Debtor and the Third Party (Garnishee). However; you find that in practice, some decisions consider the Judgment Debtor an active participant, others consider him otherwise.

The position of the Court of Appeal in the case of P.P.M.C. LTD v. DELPHI PET. INC. (2005) 8 NWLR (pt 928) 458; where the appellant, who was the judgment debtor, appealed against a garnished order; the court held the judgment debtor is not a necessary party in the garnishee proceedings and at such don't have the right of appeal (only the Garnishee 'GTB' had the right). The Court held that a Garnishee proceedings is between the judgment creditor and the Garnishee (third party) and the judgment debtor is not a necessary party.

In the case of United Bank for Africa Plc v. Hon. Boro Ekanem, which was in all fours to the case above, the Court of Appeal stated that the Garnishee is the only party expected to react where he is dissatisfied with the order nisi, stating reasons why the order nisi should not be made absolute. It added that, the Judgment Debtor is a mere busy body, meddling in affairs that is not a concern of his.

On the contrary, Ogakwu JCA in the case of Nigerian Breweries Plc v. Demure asked a rather sarcastic thetorical question.

"Now, if as contended that it isn't necessary to have the judgment debtor as a party in the garnishee proceedings, what is the essence of the provision for the order nisi to be served on him? Is it merely for his information or for him to attend Court as a spectator to applaud and cheer on the judgment creditor and garnishee in contention on the destination of funds which belong to him".

The Court of Appeal in Fidelity Bank PLC v. Okwuowulu (2012) LPELE 8497 (CA); posited that in garnishee proceedings for order nisi, the judgment debtor is not to be heard. But in the latter, it becomes a tripartite proceeding. The court held that the three parties are parties to a garnishee proceeding.

Having considered the two conflicting judgments, I agree with the later judgment which affirms the necessity of the Judgment Debtor in Garnishee Proceedings. This is predicated on the fact that, the money in dispute belongs to the Judgment Debtor. It is only fair, as provided for in Section 36 of the 1999 Constitution of the Federal Republic of Nigeria (as amended) that the Judgment Debtor is heard and as such, has a say in the Proceedings.

In addition, Section 83(1) of SCPA, provides that a judgment debtor is to be examined orally before or after the order. Thus, even though the application by the judgment creditor is brought by way of motion ex-parte for order Nisi, the judgment debtor is expected to be heard in the proceedings that would lead to the making of the order absolute.

Section 83(2) of SCPA, which makes it compulsory for the service of the order nisi on the judgment debtor at least 14days before the making of the order. As was stated in an Obiter in the case of Nigerian Breweries Plc v. Dumuje, what is the essence of the service only for the Judgment Debtor to be excluded in the proceedings?

It is worthy of note to state here that, the Judgment Debtor does not always have to be a Bank. It could be an individual, co-operative society or any Debtor to the Judgment Debtor.

B. EFFECT OF STAY OF EXECUTION IN GARNISHEE PROCEEDINGS :

Where a Judgment Creditor receives a judgment in his favour, it is not uncommon to find the Judgment Debtor who has appealed this judgment, filing an application for a stay of execution. The bone of contention here is, will the order of stay of execution stop the garnishee proceedings?

In the case of Purification Tech (Nig) LTD v. A.G Lagos State, the Court held that garnishee proceedings are independent, actions distinct from an Appeal and an application for stay of execution. As a result, the Judgment Creditor can still use a Garnishee Proceedings to enforce the judgment. The case of Denton - west v. Umuoma (2008) 6 NWLR (pt 1083) 418 at 442 is analogous to the aforementioned case.

A contrary view was postulated in Nigerian Breweries Plc and Anor v. Dumuje. It was held that garnishee proceedings could not continue as a means of execution, pending a motion for a stay of execution. The continuance of the garnishee proceedings will impose a fait accompli on a superior Court deciding the appeal. The rationale behind this decision, is to give the parties a form of assurance that the debt is in a safe custody while the contention between the parties continues. The Court further stated here that, a Judgment Debtor is a necessary party in garnishee proceedings. It is expedient to state here that this is a Court of Appeal judgment, subject to the reasoning and decision of the Supreme Court.

In conclusion, The Garnishee Proceedings requires prudence and due diligence. This is owing to the fact that the Judgment Debtor may dubiously transfer his money from the Debtor known to the Judgment Creditor to another Bank or individual.

This method of enforcing judgment is one of the most effective ways of recovering debts as opposed to threats and puffs. The Judgment Creditor here is spared the agonising process of listening to tales of the unavailability of funds and the endless wait for the fulfilment of a promise to pay. Instead, he recovers his debt directly from a third party (the Garnishee), who is in possession of the Judgment Debtor's money.

11.5 SUMMARY :

As per Clayton’s rule, each withdrawal made in a cash credit account is considered a new loan, and each deposit made to repay the loan will be applied in the order of the loan taken. It deals with appropriation of payment for discharge of debts.

Garnishee is the person who is liable to pay a debt to a debt to judgement debtor or to deliver any movable property to him. This method of enforcing judgement is one of the most effective ways of recovering debts as opposed to threats and puffs. Garnishee order is applicable to various types of accounts such as joint accounts, partnership account, trust accounts etc.

11.6 KEY WORDS:

Joint account :

A bank account, which is shared by two or more individuals.

Garnishee order :

A remedy after judgment that effectively allows your bank to make payments to any third party that you owe money to following a court order.

Claytons rule :

Whatever is paid, is paid according to the intention or manner of the party making payment.

Appropriation :

When money is set aside for a specific purpose.

Partnership account :

An Account for an unincorporated business owned by two or more individuals or entities referred to as partners.

Depositor :

A person who is making a deposit with the bank.

Insolvent :

Insolvency is a state of financial distress in which a person or business is unable to pay their debts.

11.7 SELF ASSESSMENT QUESTIONS:

1. Write about Clayton rule
2. Discuss garnishee order
3. Write the applications of garnishee order

11.8 SUGGESTED BOOKS:

1. Garnishee order & attachment order; abinash mandilwar
2. Sinkey, J.F., Commercial Bank Financial Management, Prentice Hall, New Delhi, 2002.

3. Joshi, V.C. and Joshi W., Managing Indian Banks, Response Books, New Delhi, 2002.

A.S. Kalyani

LESSION – 12

MORTGAGES AND DEPOSITS

Objectives :

After reading this lesson, one should be able to

- Understand meaning, definition of mortgages;
- Describe the various types of mortgages;
- understand the Equitable and registered mortgages

Structure of the Lesson :

12.1 An Introduction to Mortgage
12.2 Mortgage Explained
12.3 Types of Mortgages
12.4 What Is an Equitable Mortgage & Registered Mortgage?
12.5 Equitable Mortgage vs. Registered Mortgage
12.6 Deposit
12.7 Types of Deposits
12.8 Deposits Mobilization
12.9 Need for Deposits Mobilization
12.10 Summary
12.11 Key words
12.12 Self Assessment Questions
12.13 Suggested books

12.1 AN INTRODUCTION TO MORTGAGE :

Before we learn about the different types of Mortgages, let us first discuss what is a Mortgage and what is its uses.

What is Mortgage?

When property, land or any other commodity is used as collateral to borrow money or to take a loan from a lender, it is known as Mortgage. In simpler terms, when a person borrows money from a lender (bank loans) and signs up an agreement where he / she gets cash in exchange for a real estate property as a guarantee with the bank until the entire amount is repaid is called a mortgage.

A few important pointers related to Mortgage have been given below :

- The borrower and lender both are uncertain about profit / loss in case of a mortgage. The lender is uncertain if the borrower will be able to pay the sum of money back or not and in case the borrower is unable to pay the lender back, he shall be in complete loss of the asset
- If the borrower is not able to pay back the loan amount, the lender has full authority over the mortgaged product
- The one who takes the loan is called a “debtor” and the one who lends money is called the “creditor”
- Loan is a contract between the lender and borrower when one lends money and the other borrows it at a certain rate of interest. Mortgage, on the other hand, is a type of loan in which the real estate or property element is added as a guarantee if the mount is not retired to the lender.

A mortgage loan is an agreement that gives the lender the right to forfeit the mortgaged property or assets in case of failure to repay the borrowed sum and interest. An asset or real estate secures them. These types of loans are considered relatively safe as an asset secures them.

The lender has the right to sell the property to cover expenses due to the borrower’s inability to pay. Therefore, the lender’s associated risk can be low as long as the amount of loan sanctioned is less than the calculated value of the property.

Mortgage loans are an agreement between a lender and a borrower where the lender has the right to sell the property to recover costs incurred due to the borrower’s failure to pay. Economic conditions, the borrower’s credit score, income, age, and the size of the loan amount concerning the property’s worth are all factors that influence mortgage rates.

Common types of mortgages are fixed – rate mortgages, ARMs, Government-backed loans, etc.

Closing expenses Prepayment penalties, balloon clauses, interest – only features, and negative amortization are points to consider when getting a mortgage.

12.2 MORTGAGE EXPLAINED :

Mortgages work similarly to other loans. It provides a borrower with a specific amount of money for a particular period, which they should be then repay with interest. However, mortgages differ from other loans, such as personal loans or student loans. They have secured loans secured by an asset or real estate. As a result, the lender obtains a hold over it and can foreclose if the borrower doesn’t pay.

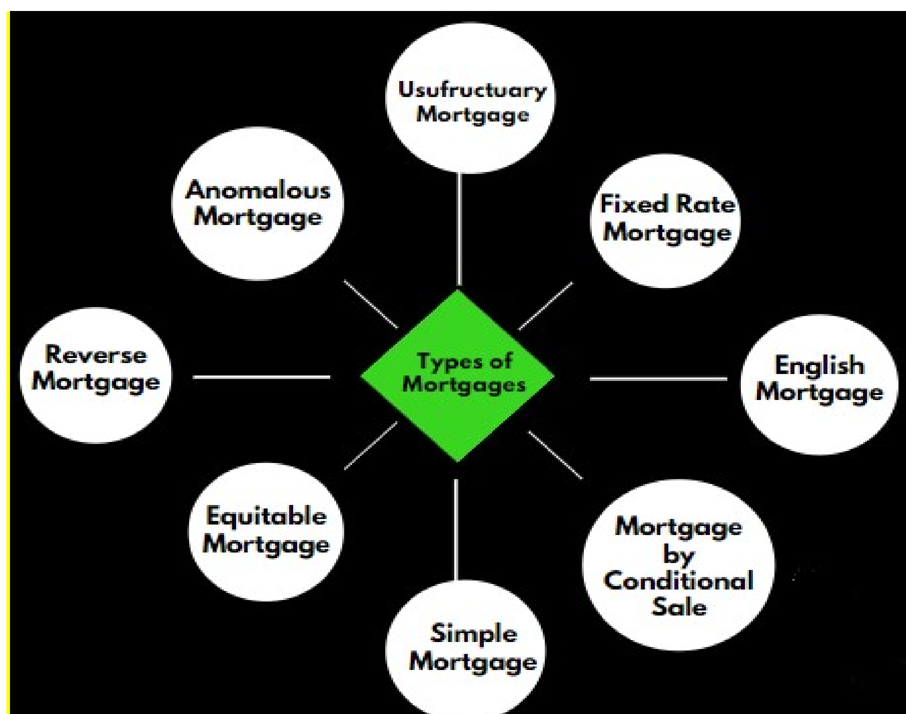
People use mortgage loans to buy any real estate or borrow money against the property’s value already owned. The property provided acts as collateral for the loan taken. The lender will assess the value of the collateral provided to let the borrower know how much

they are qualified to borrow. A simple online search can reveal the mortgage rates offered by different financial institutions. Similarly, individuals can use online calculators to calculate mortgage payments. Borrowers can also contact a mortgage broker to save time and effort during the application process. They are intermediaries who connect the borrower with the lender. However, as a precaution, the borrowers must go through the varied mortgage loans available and choose the best. This will save a lot of money by way of interest.

A type of mortgage is suited especially for senior citizens called a reverse mortgage. Like a standard mortgage, it allows owners to borrow money while securing the loan with their property. When a person takes a reverse mortgage loan, the title to the property remains in the borrower's name. Unlike the standard mortgages, they need not make monthly mortgage payments with a reverse mortgage loan. The loan is repaid when the borrower is no longer living on that property. Interest and fees are added to the loan balance every month, increasing the total. The owners or successors will have to repay the debt, typically selling the house.

12.3 TYPES OF MORTGAGES :

Discussed below are the different types of mortgages :



- Simple Mortgage : In such type of mortgage, the borrower needs to sign an agreement stating that if he / she is unable to pay back the borrowed amount in specified time duration, then the lender can sell the property to anyone to get his money back

- Mortgage by Conditional Sale : Under such mortgage, the lender can put a certain number of conditions which the borrower must follow in terms of repayment. These conditions may include the sale of the property if there is a delay in the monthly installments, an increase in the rate of interest due to delay in repayment, etc.
- English Mortgage : In this type of mortgage, the borrower has to transfer the property in the name of the lender at the time of taking money, at a condition that the property would be transferred back to the borrower once the complete amount is paid back
- Fixed – Rate Mortgage : When the lender assures the borrower that the rate of interest will remain the same throughout the loan period is called Fixed-Rate Mortgage
- Usufructuary Mortgage : This kind of mortgage gives a benefit to the lender. The lender has the right over the property for the due course of the loan period, he can put the property on rent or use it for other purposes until the repayment of the amount. But the main rights lie with the owner himself
- Anomalous Mortgage : A combination of different types of mortgages is called an Anomalous Mortgage.
- Reverse Mortgage : In this case, the lender lends money to the borrower on a monthly basis. The entire loan amount is divided into installments and the lender gives the borrower that money in installments.
- Equitable Mortgage : In this type of mortgage, the title deeds of the property are given to the lender. This is a common phenomenon in the banking mortgage loans. It is done to secure the property0.

12.4 WHAT IS AN EQUITABLE MORTGAGE & REGISTERED MORTGAGE?

'Equitable' is derived from the word equity, which means the interest of justice. This mortgage is a simple contract between a mortgagor and mortgagee (here, lender and borrower). In this mortgage type, you borrow money from the lender and furnish the documents of the property to them. The ownership documents remain with the lender until you repay the loan. These mortgages are usually for a time frame of 15 – 20, and during this tenure, your property documents remain with the lender.

Importance of Understanding Equitable Mortgages in Real Estate Transactions

- Equitable mortgages are an alternative to registered mortgages in real estate transactions.
- This type of mortgage is created by depositing the property's title deed with the lender as security for the loan amount.

- No legal procedure or registration is needed for an equitable mortgage, making it less expensive and requiring less documentation.
- The borrower benefits from the easy return of the title deed after loan repayment.
- An equitable mortgage can only be executed in places the concerned state governments notify.
- Understanding the process and implications of an equitable mortgage before entering into a real estate transaction is crucial.

Registered Mortgage?

In registered mortgage a third party is involved apart from you and the lender. In this mortgage type, you are required to voluntarily give the full right of the property to the lender. The lender has the ownership of your property, and they can use or dispose of the property in case of default. In this mortgage, you need to record the property mortgage at the sub – registrar office. When you repay the loan in full, the ownership of the property is transferred back to you.

12.5 EQUITABLE MORTGAGE VS. REGISTERED MORTGAGE :

Factors	Equitable Mortgage	Registered Mortgage
Meaning	A type of mortgage, where the terms of the agreement are made solely by mortgagor and mortgagee. They are not registered.	The mortgagor and mortgagee need to take the approval of the sub – registrar to finalize the agreement.
Process	The buyer of the property has to buy the stamp paper.	The borrower has to approach the sub – registrar's office to purchase the stamp paper.
Cost / Stamp Duty	The stamp duty ranges between 0.1– 0.2% of the total loan amount or the home value.	The stamp duty is nearly 5% of the loan amount or the home value.
Lender's Right	In case of non – payment of the loan amount, the lender takes over the property and place it for auction.	In case of non-payment of the loan amount, the lender can do whatever it wants to do with the property.
Risk Factors	The risk is higher as both parties are only bound by the agreement.	The risk is low as there are legal provisions for both borrower and the lender.

Difference Between Equitable Mortgage and Registered Mortgage :

Process : One of the key differences between the two processes is the making of the agreement itself. In an equitable mortgage you, the buyer of the property, have to buy a stamp paper. In a registered mortgage, you would need to approach the sub-registrar office for the same.

Stamp duty : One of the key differences between the two types of mortgages is stamp duty. In an equitable mortgage stamp duty is negligible and it comes to only 0.1 to 0.2% of the total loan amount. Sometimes the stamp duty is as low as 0%. However, when it comes to a registered property, the stamp duty can be nearly 5% of the total loan amount.

What happens when you don't pay: This is one of the key differences between the two processes. When you don't pay off your loan in an equitable agreement, the bank auctions off your property. However, when you don't pay off your loan in a registered mortgage, then the bank can do whatever it wants with it.

Now that we know the key differences between the two terms, let us understand which one would work for you based on certain **key parameters**.

Risk factor : There is no legal binding in an equitable agreement. Both parties are only bound by the agreement and nothing else; hence the risk is also higher. Likewise, in a registered mortgage there are legal provisions for both the lender and the borrower. Hence, the risk is lower and many times nil.

Bank preference : Banks would prefer a registered mortgage over a registered mortgage since there are legal provisions and risk is lower. Also, there are records of the property and lending in the sub registrar's office.

Understanding the difference between the two would help you opt for the suitable mortgage type as per your requirement. Usually, banks prefer a registered mortgage as it is safe and risk – free. However, if you are an old customer, and have a good relationship with the lender, you can also opt for an equitable mortgage. Keep these details in mind while applying for a loan against property for a hassle-free loan availing process.

Conclusion :

While equitable mortgage vs registered mortgage involves pledging a property to avail of a loan, they differ in registration, legal provisions, process requirements, cost, and risk. It is essential to understand the difference between simple mortgage and equitable mortgage and opt for the suitable mortgage type as per your requirements. For a hassle – free loan availing process, we recommend keeping these details in mind while applying for a loan against property.

12.6 DEPOSIT :

Introduction :

Banking is an ancient business in India. The Indian banking system is unique due to its geographic, social and economic characteristics and perhaps has no parallels in the annals of banking in the world. The period of five decades witnessed many macro-economic developments, changes in monetary and banking policies and the external forces that influenced the evolution of the Indian banking system in different ways over a period of time. In this chapter, a sincere attempt has been made to highlight the banking sector reforms, conceptual framework of deposits and their mobilization by banks in India and the salient features of deposit mobilization by scheduled commercial banks (SCBs) in India. The strategies adopted by the Central Government and Reserve Bank of India (RBI) to increase the level of deposit mobilization by banks have also been evaluated.

Banking System in India :

Scheduled Commercial Banks (SCBs) account for a major proportion of the total business, of the Scheduled Commercial Banks. As at end March, 2013, 89 Scheduled Commercial Banks were operational in India. Scheduled Commercial Banks are categorized into five groups based on their ownership and nature of operations. State Bank of India (SBI) and its six associates (excluding State Bank of Saurashtra, which has been merged with the SBI with effect from August 13,2008) are recognized as a separate category of Scheduled Commercial Banks, because of the distinct status(State Bank of India Act,1955 and State Bank of India Subsidiary Banks Act.1959) that govern them. Nationalized banks (20) and State Bank of India and associates (6), together form the public sector banks group and control around 83 per cent of branches in India. Industrial Development Bank of India Ltd has been included among the nationalized banks in December 2004. Private Sector Banks include the Old Private Sector banks and the new generation private sector banks. Which were incorporated according to the revised guidelines issued by the RBI regarding the entry of private Sector banks in 1993. As of March 2013, there were 13 old and 7 new generation private sector banks operating in India.

12.7 TYPES OF DEPOSITS :

Commercial bank Act 2031, defines deposits is the amounts deposited in a current, saving or fixed a/c of a bank or financial institution. People in general, the businessmen; the industrialist & other individuals deposit money in a bank. Bank flow such amount as loan & invests in different sectors to earn profit. Bank accepts deposits in current, saving & fixed deposits. In Nepal, banks grant permission to their customers to open three types of a/c under various terms & conditions. This classification is made on different theoretical & financial basis.

Therefore, deposits of bank are classified on the following basis :

i) Demand Deposits ii) Saving Deposits iii) Fixed deposits

i) Demand Deposits :

The deposit in which an amount is immediately paid at the time of any a/c holder's demand is called demand deposits. In another words, we can say this type of demand deposit as current a/c. Current a/c means an a/c of amounts deposited in a bank, which may be drawn at any time on demand. Its transaction is continual & such deposit can't be invested in the productive sector, so such type of amount remains as stock in the bank. Though the bank can't gain profit by investing it in new sector after taking from the customers, this facility is given to the customer. Therefore, the bank doesn't give interest on this account. From such deposit, the merchant & traders are benefited more than the individual. The bank should pay as many times as the cheque is sent until there is deposit in his a/c. The bank can't impose any condition & restrictions in demand deposit. An institution or an individual, who usually needs money daily, precedes their acts & transaction through such deposit. The current a/c is very important for the customers of bank.

ii) Saving Deposits :

The bank can collect capital through the saving deposit as well. This deposit is also important & its necessity & scope is not negligible. According to the Commercial bank Act 2031, saving accounts means an a/c of amounts deposited in a bank for savings purposes. This account is suitable & appropriate for the people of middle class, farmers and the labors who have low income, official & small businessmen. This saving deposit bears the features of both of the current & fixed period deposits. Generally, most accounts are opened saving deposit in a bank.

Therefore, the deposit is popular in people in general. According to internal rules or banks some banks demand a small amount & some banks demand a great deal of money to open saving account. Different banks have made different rules. Some banks have made one hundred thousand, some banks have made two hundred thousand, some have three hundred thousand, some have five hundred thousand & some have not fixed the limitation. So, there is divergence as to how much amount of money can be withdrawn. Banks give some interest on it.

iii) Fixed Deposits :

Under the commercial Bank Act 2031: fixed account means an account of amounts deposited in a bank for certain period of time. The customers opening such account deposit their money in this account, for a fixed period. In the other words, it is called time deposit because this account is deposited for a certain period.

Usually, only the person or institution who wants to gain more interest opens such type of account. The period of time can be 3 months, 6 months, 9 months, 1 year, 2years, 3 tears, 4 years, 5 years etc. More interest rate is payable in this deposit than other deposit. Both parties the bank & the customers can take benefit from this deposit. The banks invest this money on the productive sector & gains profit & the customers too can be made his financial transaction stronger by getting more interest from this deposit. The amount in the

saving deposit must be returned to the customers after date is expires. The amount can't be withdrawn before the fixed time.

12.8 DEPOSITS MOBILIZATION :

"Collecting scattered small amount of capital through different Medias, investing the deposited fund in productive sector with a view to increase the income of the depositor is meant deposit mobilization. In other words, investing the collected fund in the productive sectors & increasing the income of the depositor is also known as deposit mobilization. It also supports to increase the saving through the investment of increased extra amount".

When we discuss about Deposit Mobilization, "we are concerned with increasing the income of the low income group of people & to make them able to save more so that they can invest again the collected amount in the development activities. The main objective of Deposit Mobilization is to convert idle saving into active saving". Saving refers to that part of the total income which is more than the expenditure of the individual. In other words, saving equals total income minus total expenditure. Basically saving can be divided into two parts: Voluntary saving & Compulsory Savings. Amount deposited in different accounts of Commercial Bank, investment in government securities are some examples of voluntary saving. A commercial bank collects deposit through different accounts like fixed, saving & current.

In developing countries there is always shortage of the capital for development activities. There is need of development in all sectors. It is not possible to handle & develop all the sectors by the government alone at a time, also private people can not undertake large business because the per capita income of the people is very low while their tendency consumes is very high. Due to the low income their saving is very low and capital formation is also very low. So their saving is not sufficient to carry out development work.

To achieve higher rate of growth and per capita income, economic development should be accelerated. "Economic development may be defined in a very broad sense, as a process of raising income per head through the accumulation of capital. There are two ways of capital accumulation, one from the external and other from the internal sources. In the first one foreign Aid, Loans and grants are the main. While in the later, financial institution operating within the country, play in a dominant role. In the context of Nepal, commercial bank is the main financial institution which can play very important role in the resource mobilization for the economic development in the country. Trade, industry, agriculture and commerce should be developed for the economic development.

Economic development so defined is necessary and sufficient to generate rate of saving and investment. The generation of high rates of saving and there by investment is possible only through the commercial banks. Commercial banks occupies greater role in economic development by generating the saving towards the desired sectors from one place to another, communicating with its branches and agencies in different part of the country and the world and advising to the commercial people." Increasing the income of the low income

group of people and making them able to save more, deposit mobilization helps to invest the collected deposit in desired sector". The saving growth rate depends upon various factors such as level of country's per capita income, its growth rate, population growth rate, interest rate in saving, bank account, banking and financial facilities and net income factor etc. The national income is the measure of the nation from the economic activities. Saving is the excess of income over consumption. Investment is the expenditure made for the formation of fixed capital. Mobilization of saving implies transfer of resources from surplus spending unit to deficit units. In this connection, financial intermediaries play an important role in mobilizing voluntary saving.

The amount of saving of a typical household in Nepal is small because the people have limited opportunities for investment. They prefer to spend saving on commodities rather than on financial assets. These restricts the process of financial intermediation, which might otherwise bring such as reduction of investment risk and increase in liquidity when capital is highly mobile internally, saving from abroad can also finance the investment needed at home. When capital is not mobile internally, saving from abroad will limit the investment at home.

Insurance of bank deposits, creation of proper atmosphere can increase deposits and the development of severity of capital markets with the helps of banks will prove effective in mobilizing the available floating resources in the country. Capital formation is possible through collecting scattered unproductive and small saving from the people. This collected fund can be utilized in productive sector to increase employment and national productivity. Deposit mobilization is the most dependable and important sources of capital formation. Banking transaction refers to the acceptance of deposits from the people for granting loan and advances, and returning the accepted deposit at demand or after the expiry of a certain period. According to banking rules and regulations, this definition clearly states that Deposit mobilization is the starting point of banking transactions.

Banking activities can be increased as much as we can mobilize the accumulated deposit effectively. Deposit, such as current, saving and fixed are the main part of the working Capital. It is due to this reason that banks keep their deposit mobilization campaign always in full swing taking resort every possible means laying at their way. “A Commercial bank changes the scattered unproductive small saving into loan able & active savings. The bank not only collect saving, but also provides incentives to the saver & help them to be able to save more”. Commercial banks are set up with a view to mobilize national resources. The first condition of National Economic Development is to be able to collect more & more deposit. In this context, the yearly increasing rate of commercial banks deposit clearly shows the satisfactory progress of deposit mobilization.

12.9 NEED FOR DEPOSITS MOBILIZATION :

The following are some reasons for why Deposit Mobilization is needed in a developing country like Nepal. Workshop report “Deposit Mobilization why & how” Group “A” states the following points as the need for deposit mobilization. Capital is needed for the development of any sector of the country. The objective of Deposit Mobilization is to collect

the scattered capital in different forms within the country. It is much more important to channelize the collected deposit in the priority sector of a country. For the development of country we have to promote our business & other sectors by investing the accumulated capital towards productive sectors.

The need of deposit mobilization is felt to control unnecessary expenditure. If there is no saving, the extra money that the people have, can flow forwards buying unnecessary & luxury goods. So, the government should also help to collect more deposit, steeping legal procedures to control unnecessary expenditures.

Commercial banks are playing a vital role for National Development. Deposit mobilization is necessary to increase their activities. Commercial banks are granting loan not only in productive sectors, but also in other sectors like food grains, gold & silver etc. though these loans are traditional in nature & are not helpful to increase productivity, but it helps some extent to mobilize bank deposit.

To increase saving is to mobilize deposit. It is because if the production of agricultural & industrial products increases, it gives additional income, which helps to save more & ultimately it plays a good role in deposit mobilization. Deposit mobilization plays a vital role for the economic development of an under developed & developing country, rather than developed one. It is because; a developed country does not feel the need of deposit mobilization for Under Developed Country (UDC) &developing country.

Deposit mobilization plays a great role in such countries. Low National Income, Low per Capita Income, lack of technical knowledge, unsound cycle of poverty, lack of irrigation & fertilizer, pressure of increased population, geographical condition etc. are the main problem of Economic Development of an UDC like Nepal.

So far the developments of these sectors are concerned; there are needs of more capital. Again, instead of the development of a particular sector, the development of every sector should go side by side. So, the development process of these sectors on one side & to accumulate the scattered & unproductive sectors deposit on the other is the felt need of an UDC. We can take this in our country's present context.

Deposit Mobilisation :

The saving and investment process in an economy is organized around a financial framework which facilitates economic growth. A well designed financial system promotes growth through effective mobilization of savings and their allocation to the most productive uses by either following a centralized approach or a decentralized approach or a combination of both. Typically, economies with underdeveloped capital markets adopt a centralized approach whereby financial intermediaries mobilize resources from savers and allocate them to borrowers. Traditionally, banks have played a curtail role in the financial intermediation process as they are able to deal more appropriately with transaction costs and information asymmetries in a financial system. As financial markets develop, transaction costs and information asymmetries reduce, the decentralized approach for guiding the saving-

investment process also gains significance and household with surplus resources increasingly invest in capital market instruments. The empirical experience shows that virtually all the economies, including the market intermediated ones, banks have played a key role in resource mobilization, supporting the growth process, and the development of bank and other intermediaries thereby facilitating the development of financial markets.

Western India :

Western India consists of the states of Goa, Gujarat, and Maharashtra along with the Union territory of Daman and Diu and Dadra and Nagar Haveli of India. The region is highly industrialized, with a large urban population. Roughly, Western India is bounded by the Thar Desert in the northwest, the Vindhya Range in the north and the Arabian Sea in the west. A major portion of Western India shares the Deccan Plateau with South India. Before the partition of India, the now-Pakistani territories of Sindh and Balochistan were also included in this region.

Review of Literature :

Francis Appiah – Kubi Banson, Emmanuel Sey, Jonathan Sakoe (2010), in his analysis, "**The Role of Mobile Deposit in Deposit Mobilization in Ghana",** as a result that mobile deposit is a 24 hours a day 7 days a week service which makes inconvenient for customers to deposit money anytime, anywhere. It has reduced queuing at FCP's banking hall, encouraged the culture of saving, especially among low income earners reduced the risk associated with carrying money to the bank to deposit and reduced the time and cost of travelling to the bank to deposit money. The mobile deposit solution through the use of speed Banking cards has proven to be a complementary deposit system.

S. Venkateshan (2012) In the study entitled "**An Empirical Approach to Deposit Mobilization of Commercial Banks in Tamilnadu".** The researcher made an attempt to study the trend and growth in deposit mobilization of Scheduled Commercial Banks in Tamil Nadu during the period from 1999-2000 to 2008-2009. The Compound Growth Rate (CGR) and Linear Growth Rate (LGR) were calculated from using simple regression analysis. The study found that, there has been a remarkable growth in mobilization of all kinds of deposits in Scheduled Commercial Banks in Tamil Nadu on the Whole.

Methodology :

The present study was mainly based on secondary data. The secondary data have been used to analyze the deposit mobilization of commercial banks. The required secondary data were collected from RBI website.

12.10 SUMMARY :

Mortgages means a person borrows money from a lender and signs up an agreement where he/she gets cash in exchange for a real estate property as a guarantee with the bank until the entire amount is repaid. It is similar to other loans. It provides a borrower with a specific amount of money for a particular period, which they should be then repay with

interest. Banks offer different types of mortgages which are classified using different criteria. In order to guide the lending activity banks develop mortgage policies.

In this chapter, a sincere attempt has been made to highlight the banking sector reforms, conceptual framework of deposits and their mobilization by banks in India and the salient features of deposit mobilization by scheduled commercial banks (SCBs) in India. The strategies adopted by the Central Government and Reserve Bank of India (RBI) to increase the level of deposit mobilization by banks have also been evaluated.

12.11 KEY WORDS :

Mortgage :

Mortgage is transfer of an interest in immovable property.

Debtor :

A person who owes a specific debt (usually money) to another person.

Usufructuary:

A legal right granted to a person or party which grants a temporary right to use / derive income / benefit from the property of another individual.

Equitable :

Equitable means fair or impartial.

Businessman:

Someone who owns or operates a business.

Mobilization :

Intended to function as a legitimate means to resolve conflicts, redress rule of law and justice deficits and address other governance problems.

Accumulation :

Increase or growth by addition especially when continuous or repeated.

Investment :

It means to put money in a certain manner so that it will generate revenue.

12.12 SELF ASSESSMENT QUESTIONS :

1. Define equitable & registered mortgage.
2. Differences between equitable mortgage and registered mortgage.
3. Write about deposit mobilization.

12.13 SUGGESTED BOOKS :

1. Banking theory and law & practice, S. N. Maheswari & R. R. Paul

2. Banking law and practice, Kalikundrikar, Kembhavi, Nataraj – Himalay Publishing house.
3. Control of Commercial Banks in india, Dr. Mohammad Quddus.

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