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BANKING

N.T. Somashekar

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N.T. Somashekar
DOS in Economics
Department of Economics
Government Arts College
Hassan, Karnataka

PUBLISHING FOR ONE WORLD

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PREFACE

There are many excellent text books on Banking written by well known British and American writers. However, none of these can claim to cover the entire course of study prescribed by the Indian Universities. Moreover, most of these books are above the understanding of an average Indian student of Commerce and Economics. The present book is a humble effort in this direction.

On account of the growing importance of the banking industry, most of the Indian Universities have introduced a special paper on Banking for their degree students. The present volume has been made to cover the syllabi of B.Com., B.B.M., M.B.A., M.Com., M.A., L.L.B., etc. In addition, I hope, it will also be of benefit to candidates appearing for various competitive examinations such as I.A.S., I.E.S., C.A., N.E.T., and I.I.B. examinations. The present volume contains 19 chapters devoted mainly to the study of Commercial Banks, Central Bank, Reserve Bank of India, State Bank of India, Money and Capital Markets, Indian Banking Systems, Banker and Customer Relationship, Operation of Bank Accounts, Collection and Payment of Cheques, Loans and Advances, Types of Securities, Modes of Creating Charge, Guarantee, Letter of Credit, Accounts and Audit of Banks. The last chapter contains multiple choice and short-type questions for the benefit of the candidates who want a deeper insight into Banking.

While preparing this book, I have collected the relevant material from government publications, published and unpublished sources, books, journals and articles by eminent scholars. My Principal, colleagues and friends have offered me valuable suggestions in the preparation of the manuscript. My sincere thanks are due to all of them.

I have a great pleasure in expressing my profound gratitude to my revered Research Supervisor Dr. S. Mahendra Kumar M.A., Ph.D., Department of Economics, Manasagangothri, Mysore, who has contributed a lot for improving the quality of this volume. He has always been a source of constant inspiration to me as a friend, philosopher and guide. I also express my deep sense of gratitude to Dr. Gopal Singh, Co-ordinator, DOS in Economics, Govt. Arts College, Hassan, Dr. K. A. Rajanna, Prof. H.K. Lalithadavi, Sri. Mahalinga (Sapna Book House); Bangalore, H.S. Ravindra, Channarayapattna, Prof. K.T. Krishnegowda, R. Radhakrishna Hassan; Sudharshan,

Marketing Manager and Srinath, Branch Manager, New Age, Bangalore; Prof. T.N. Prabhakar, Principal, Government Arts College, Hassan and my friends for rendering assistance in various forms in preparing the manuscript of this book.

I also express my grateful thanks to New Age International Publishers, New Delhi for bringing out this book in a record time. Thanks are also due to Madusudan, DATA LINK, Bangalore for typing the manuscript with efficiency and patience.

Last, but not the least, I acknowledge with a sense of gratitude the services of my wife, Smt. **Sujatha Somashekar** and my son, **N.S. Swaroop**, who not only left no stone unturned in providing me a congenial atmosphere for studies at home, but also relieved me from a number of family responsibilities and even more, at times, directly helped me in my work.

Any suggestion for enhancing the value of the book from students and teachers, would be most welcome and would be kept in view at the time of bringing out the second edition. With these words, I present this book to students, who alone will judge its worth.

Ne. Thi. Somashekar

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1

Commercial Banking

INTRODUCTION

Banking occupies one of the most important positions in the modern economic world. It is necessary for trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. Its presence is very helpful to the economic activity and industrial progress of a country.

Meaning

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in the sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advances out of the funds received as deposits to needy people. It thus, functions as a mobiliser of saving in the economy. A bank is, therefore like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and others who need them for investment or productive uses.

Definition of a Bank

The term 'Bank' has been defined in different ways by different economists. A few definitions are:

According to Walter Leaf "A bank is a person or corporation which holds itself out to receive from the public, deposits payable on demand by cheque." Horace White has defined a bank, "as a manufacture of credit and a machine for facilitating exchange."

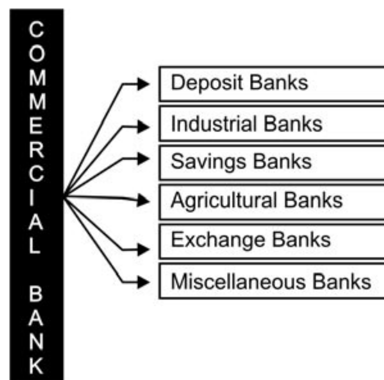
According to Prof. Kinley, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use."

The Banking Companies Act of India defines Bank as "A Bank is a financial institution which accepts money from the public for the purpose of lending or investment repayable on demand or otherwise withdrawable by cheques, drafts or order or otherwise."

Thus, we can say that a bank is a financial institution which deals in debts and credits. It accepts deposits, lends money and also creates money. It bridges the gap between the savers and borrowers. Banks are not merely traders in money but also in an important sense manufacturers of money.

TYPES OF BANKS

Broadly speaking, banks can be classified into commercial banks and central bank. Commercial banks are those which provide banking services for profit. The central bank has the function of controlling commercial banks and various other economic activities. There are many types of commercial banks such as deposit banks, industrial banks, savings banks, agricultural banks, exchange banks, and miscellaneous banks.



Types of Commercial Banks

1. **Deposit Banks:** The most important type of deposit banks is the commercial banks. They have connection with the commercial class of people. These banks accept deposits from the public and lend them to needy parties. Since their deposits are for short period only, these banks extend loans only for a short period. Ordinarily these banks lend money for a period between 3 to 6 months. They do not like to lend money for long periods or to invest their funds in any way in long term securities.
2. **Industrial Banks:** Industries require a huge capital for a long period to buy machinery and equipment. Industrial banks help such industrialists. They provide long term loans to industries. Besides, they buy shares and debentures of companies, and enable them to have fixed capital. Sometimes, they even underwrite the debentures and shares of big industrial concerns. The important functions of industrial banks are:

1. They accept long term deposits.
2. They meet the credit requirements of industries by extending long term loans.
3. These banks advise the industrial firms regarding the sale and purchase of shares and debentures.

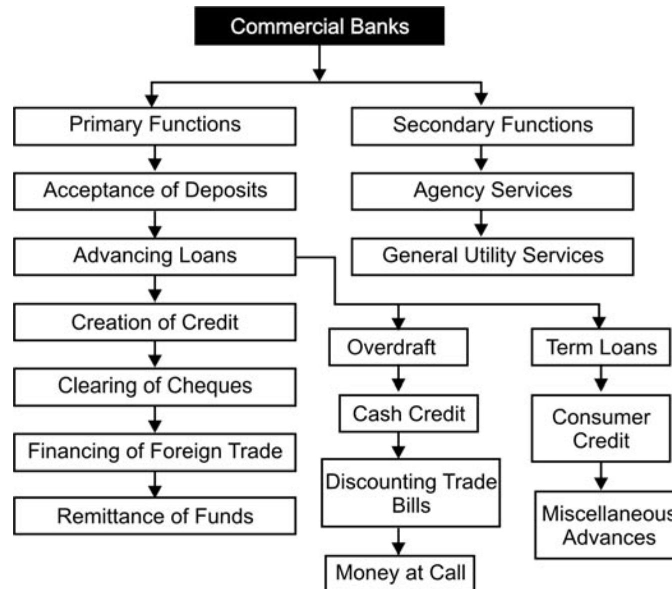
The industrial banks play a vital role in accelerating industrial development. In India, after attainment of independence, several industrial banks were started with large paid up capital. They are, The Industrial Finance Corporation (I.F.C.), The State Financial Corporations (S.F.C.), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) etc.

3. **Savings Banks:** These banks were specially established to encourage thrift among small savers and therefore, they were willing to accept small sums as deposits. They encourage savings of the poor and middle class people. In India we do not have such special institutions, but post offices perform such functions. After nationalisation most of the nationalised banks accept the saving deposits.
4. **Agricultural Banks:** Agriculture has its own problems and hence there are separate banks to finance it. These banks are organised on co-operative lines and therefore do not work on the principle of maximum profit for the shareholders. These banks meet the credit requirements of the farmers through term loans, viz., short, medium and long term loans. There are two types of agricultural banks,
   (a) Agricultural Co-operative Banks, and
   (b) Land Mortgage Banks. Co-operative Banks are mainly for short periods. For long periods there are Land Mortgage Banks. Both these types of banks are performing useful functions in India.
5. **Exchange Banks:** These banks finance mostly for the foreign trade of a country. Their main function is to discount, accept and collect foreign bills of exchange. They buy and sell foreign currency and thus help businessmen in their transactions. They also carry on the ordinary banking business.

   In India, there are some commercial banks which are branches of foreign banks. These banks facilitate for the conversion of Indian currency into foreign currency to make payments to foreign exporters. They purchase bills from exporters and sell their proceeds to importers. They purchase and sell "forward exchange" too and thus minimise the difference in exchange rates between different periods, and also protect merchants from losses arising out of exchange fluctuations by bearing the risk. The industrial and commercial development of a country depends these days, largely upon the efficiency of these institutions.
6. **Miscellaneous Banks:** There are certain kinds of banks which have arisen in due course to meet the specialised needs of the people. In England and America, there are investment banks whose object is to control the distribution of capital into several uses. American Trade Unions have got labour banks, where the savings of the labourers are pooled together. In London, there are the London Discount House whose business is "to go about the city seeking for bills to discount." There are numerous types of different banks in the world, carrying on one or the other banking business.

FUNCTIONS OF COMMERCIAL BANKS

Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.



A. *Primary Functions*

Primary banking functions of the commercial banks include:

1. Acceptance of deposits
2. Advancing loans
3. Creation of credit
4. Clearing of cheques
5. Financing foreign trade
6. Remittance of funds

1. **Acceptance of Deposits:** Accepting deposits is the primary function of a commercial bank mobilise savings of the household sector. Banks generally accept three types of deposits viz., (a) Current Deposits (b) Savings Deposits, and (c) Fixed Deposits.
   (a) *Current Deposits:* These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make

large payments through banks. The bank levies certain incidental charges on the customer for the services rendered by it.

(b) *Savings Deposits:* This is meant mainly for professional men and middle class people to help them deposit their small savings. It can be opened without any introduction. Money can be deposited at any time but the maximum cannot go beyond a certain limit. There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. The rate of interest is greater than the rate of interest on the current deposits and less than that on fixed deposit. This system greatly encourages the habit of thrift or savings.

(c) *Fixed Deposits:* These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest. In India, they are accepted between three months and ten years.

2. **Advancing Loans:** The second primary function of a commercial bank is to make loans and advances to all types of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common way of lending is by:

(a) *Overdraft Facilities:* In this case, the depositor in a current account is allowed to draw over and above his account up to a previously agreed limit. Suppose a businessman has only Rs. 30,000/- in his current account in a bank but requires Rs. 60,000/- to meet his expenses. He may approach his bank and borrow the additional amount of Rs. 30,000/-. The bank allows the customer to overdraw his account through cheques. The bank, however, charges interest only on the amount overdrawn from the account. This type of loan is very popular with the Indian businessmen.

(b) *Cash Credit:* Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the amount of credit availed to him. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him. Besides, the bank can also give specified loan to a person, for a firm against some collateral security. The bank can recall such loans at its option.

(c) *Discounting Bills of Exchange:* This is another type of lending which is very popular with the modern banks. The holder of a bill can get it discounted by the bank, when he is in need of money. After deducting its commission, the bank

pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide a very liquid asset which can be quickly turned into cash. The commercial banks can rediscount, the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

(d) *Money at Call:* Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers, usually dealers or brokers in stock exchange markets against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence, they are described as money at call or call money.

(e) *Term Loans:* Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans, as such provide intermediate or working capital funds to the borrowers. Sometimes, two or more banks may jointly provide large term loans to the borrower against a common security. Such loans are called participation loans or consortium finance.

(f) *Consumer Credit:* Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc. Such consumer credit is made in a lump sum and is repayable in instalments in a short time. Under the 20-point programme, the scope of consumer credit has been extended to cover expenses on marriage, funeral etc., as well.

(g) *Miscellaneous Advances:* Among other forms of bank advances there are packing credits given to exporters for a short duration, export bills purchased/discounted, import finance-advances against import bills, finance to the self employed, credit to the public sector, credit to the cooperative sector and above all, credit to the weaker sections of the community at concessional rates.

3. **Creation of Credit:** A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money. Bank deposits are regarded as money. They are as good as cash. The reason is they can be used for the purchase of goods and services and also in payment of debts. When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit. Sayers says "banks are not merely purveyors of money, but also in an important sense, manufacturers of money."

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

5. **Financing Internal and Foreign Trade:** The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.
6. **Remittance of Funds:** Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges. As compared to the postal money orders or other instruments, bank drafts have proved to be a much cheaper mode of transferring money and has helped the business community considerably.

B. Secondary Functions

Secondary banking functions of the commercial banks include:

1. Agency Services
2. General Utility Services

These are discussed below.

1. **Agency Services:** Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large. The various agency services rendered by banks are as follows:
   (a) *Collection and Payment of Credit Instruments:* Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc., on behalf of their customers.
   (b) *Purchase and Sale of Securities:* Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.
   (c) *Collection of Dividends on Shares:* Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.
   (d) *Acts as Correspondent:* Sometimes banks act as representative and correspondents of their customers. They get passports, traveller's tickets and even secure air and sea passages for their customers.
   (e) *Income-tax Consultancy:* Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.
   (f) *Execution of Standing Orders:* Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia etc., on behalf of their customers.
   (g) *Acts as Trustee and Executor:* Banks preserve the 'Wills' of their customers and execute them after their death.
2. **General Utility Services:** In addition to agency services, the modern banks provide many general utility services for the community as given.

(a) *Locker Facility:* Bank provide locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.

(b) *Traveller's Cheques and Credit Cards:* Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.

(c) *Letter of Credit:* Letters of credit are issued by the banks to their customers certifying their credit worthiness. Letters of credit are very useful in foreign trade.

(d) *Collection of Statistics:* Banks collect statistics giving important information relating to trade, commerce, industries, money and banking. They also publish valuable journals and bulletins containing articles on economic and financial matters.

(e) *Acting Referee:* Banks may act as referees with respect to the financial standing, business reputation and respectability of customers.

(f) *Underwriting Securities:* Banks underwrite the shares and debentures issued by the Government, public or private companies.

(g) *Gift Cheques:* Some banks issue cheques of various denominations to be used on auspicious occasions.

(h) *Accepting Bills of Exchange on Behalf of Customers:* Sometimes, banks accept bills of exchange, internal as well as foreign, on behalf of their customers. It enables customers to import goods.

(i) *Merchant Banking:* Some commercial banks have opened merchant banking divisions to provide merchant banking services.

C. Fulfillment of Socio-Economic Objectives

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

It is clear from the above that banks help development of trade and industry in the country. They encourage habits of thrift and saving. They help capital formation in the country. They lend money to traders and manufacturers. In the modern world, banks are to be considered not merely as dealers in money but also the leaders in economic development.

SOURCES OF BANK'S INCOME

A bank is a business organisation engaged in the business of borrowing and lending money. A bank can earn income only if it borrows at a lower rate and lends at a higher rate. The difference between the two rates will represent the costs incurred by the bank and the profit. Bank also provides a number of services to its customers for which it charges commission. This is also an important source of income. The followings are the various sources of a bank's profit:

1. **Interest on Loans:** The main function of a commercial bank is to borrow money for the purpose of lending at a higher rate of interest. Bank grants various types of loans to the industrialists and traders. The yields from loans constitute the major portion of the income of a bank. The banks grant loans generally for short periods. But now the banks also advance call loans which can be called at a very short notice. Such loans are granted to share brokers and other banks. These assets are highly liquid because they can be called at any time. Moreover, they are source of income to the bank.
2. **Interest on Investments:** Banks also invest an important portion of their resources in government and other first class industrial securities. The interest and dividend received from time to time on these investments is a source of income for the banks. Bank also earn some income when the market prices of these securities rise.
3. **Discounts:** Commercial banks invest a part of their funds in bills of exchange by discounting them. Banks discount both foreign and inland bills of exchange, or in other words, they purchase the bills at discount and receive the full amount at the date of maturity. For instance, if a bill of Rs. 1000 is discounted for Rs. 975, the bank earns a discount of Rs. 25 because bank pays Rs. 975 today, but will get Rs. 1000 on the due date. Discount, as a matter of fact, is the interest on the amount paid for the remaining period of the bill. The rate of discount on bills of exchange is slightly lower than the interest rate charged on loans and advances because bills are considered to be highly liquid assets.
4. **Commission, Brokerage, etc.:** Banks perform numerous services to their customers and charge commission, etc., for such services. Banks collect cheques, rents, dividends, etc., accepts bills of exchange, issue drafts and letters of credit and collect pensions and salaries on behalf of their customers. They pay insurance premiums, rents, taxes etc., on behalf of their customers. For all these services banks charge their commission. They also earn locker rents for providing safety vaults to their customers. Recently the banks have also started underwriting the shares and debentures issued by the joint stock companies for which they receive underwriting commission.

Commercial banks also deal in foreign exchange. They sell demand drafts, issue letters of credit and help remittance of funds in foreign countries. They also act as brokers in foreign exchange. Banks earn income out of these operations.

INVESTMENT POLICY OF BANKS

The financial position of a commercial bank is reflected in its balance sheet. The balance sheet is a statement of the assets and liabilities of the bank. The assets of the bank are distributed in accordance with certain guiding principles. These principles underline the investment policy of the bank. They are discussed below:

1. **Liquidity:** In the context of the balance sheet of a bank the term liquidity has two interpretations. First, it refers to the ability of the bank to honour the claims of the depositors. Second, it connotes the ability of the bank to convert its non-cash assets into cash easily and without loss.

   It is a well known fact that a bank deals in funds belonging to the public. Hence, the bank should always be on its guard in handling these funds. The bank should always have enough cash to meet the demands of the depositors. In fact, the success of a bank depends to a considerable extent upon the degree of confidence it can instill in the minds of its depositors. If the depositors lose confidence in the integrity of their bank, the very existence of the bank will be at stake. So, the bank should always be prepared to meet the claims of the depositors by having enough cash. Among the various items on the assets side of the balance sheet, cash on hand represents the most liquid asset. Next comes cash with other banks and the central bank. The order of liquidity goes on descending.

   Liquidity also means the ability of the bank to convert its non-cash assets into cash easily and without loss. The bank cannot have all its assets in the form of cash because each is an idle asset which does not fetch any return to the bank. So some of the assets of the bank, money at call and short notice, bills discounted, etc. could be made liquid easily and without loss.
2. **Profitability:** A commercial bank by definition, is a profit hunting institution. The bank has to earn profit to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and to meet the day-to-day expenditure. Since cash is the least profitable asset to the bank, there is no point in keeping all the assets in the form of cash on hand. The bank has got to earn income. Hence, some of the items on the assets side are profit yielding assets. They include money at call and short notice, bills discounted, investments, loans and advances, etc. Loans and advances, though the least liquid asset, constitute the most profitable asset to the bank. Much of the income of the bank accrues by way of interest charged on loans and advances. But, the bank has to be highly discreet while advancing loans.
3. **Safety or Security:** Apart from liquidity and profitability, the bank should look to the principle of safety of its funds also for its smooth working. While advancing loans, it is necessary that the bank should consider the three 'C' s of credit character, capacity and the collateral of the borrower. The bank cannot afford to invest its funds recklessly without considering the principle of safety. The loans and investments made by the bank should be adequately secured. For this purpose, the bank should

always insist on security of the borrower. Of late, somehow or other the banks have not been paying adequate importance to safety, particularly in India.

4. **Diversity:** The bank should invest its funds in such a way as to secure for itself an adequate and permanent return. And while investing its funds, the bank should not keep all its eggs in the same basket. Diversification of investment is necessary to avoid the dangerous consequences of investing in one or two channels. If the bank invest its funds in different types of securities or makes loans and advances to different objectives and enterprises, it shall ensure for itself a regular flow of income.
5. **Saleability of Securities:** Further, the bank should invest its funds in such types of securities as can be easily marketed at a time of emergency. The bank cannot afford to invest its funds in very long term securities or those securities which are unsaleable. It is necessary for the bank to invest its funds in government or in first class securities or in debentures of reputed firms. It should also advance loans against stocks which can be easily sold.
6. **Stability in the Value of Investments:** The bank should invest its funds in those stocks and securities the prices of which are more or less stable. The bank cannot afford to invest its funds in securities, the prices of which are subject to frequent fluctuations.
7. **Principles of Tax-Exemption of Investments:** Finally, the investment policy of a bank should be based on the principle of tax exemption of investments. The bank should invest in those government securities which are exempted from income and other taxes. This will help the bank to increase its profits.

Of late, there has been a controversy regarding the relative importance of the various principles influencing the investment policy of a bank particularly between liquidity and profitability. It is interesting to examine this controversy.

Let us examine what happens if the bank sticks to the principle of liquidity only. It is true that if the bank pays importance to liquidity, it can easily meet the demands of the depositors. The bank should have adequate cash to meet the claims of the depositors. It is true that a successful banking business calls for installing confidence in the minds of the depositors. But, it should be noted that accepting deposits is not the only function of a bank. Moreover, the bank cannot afford to forget the fact that it has to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and meet the day-to-day expenditure. If the bank keeps all its resources in liquid form, it will not be able to earn even a rupee. But profitability is a must for the bank. Though cash on hand is the most liquid asset, it is the least profitable asset as well. Cash is an idle asset. Hence, the banker cannot concentrate on liquidity only.

If the bank attaches importance to profitability only, it would be equally disastrous to the very survival of a bank. It is true that a bank needs income to meet its expenditure and pay returns to the depositors and shareholders. The bank cannot undermine the interests of the depositors. If the bank lends out all its funds,

it will be left with no cash at all to meet the claims of the depositors. It should be noted that the bank should have cash to honour the obligations of the depositors. Otherwise, there will be a 'run' on the bank. A run on the bank would be suicidal to the very existence of the bank. Loans and advances, though the most profitable asset, constitute the least liquid asset.

It follows from the above that the choice is between liquidity and profitability. The constant tug of war between liquidity and profitability is the feature of the assets side. According to Crowther, liquidity and profitability are opposing or conflicting considerations. The secret of successful banking lies in striking a balance between the two.

BALANCE SHEET OF THE BANK

The balance sheet of a commercial bank is a statement of its assets and liabilities. Assets are what others owe the bank, and what the bank owes others constitutes its liabilities. The business of a bank is reflected in its balance sheet and hence its financial position as well. The balance sheet is issued usually at the end of every financial year of the bank.

The balance sheet of the bank comprises of two sides; the assets side and the liabilities side. It is customary to record liabilities on the left side and assets on the right side. The following is the proforma of a balance sheet of the bank.

Balance Sheet of the Bank

Liabilities	Assets
1. Capital	1. Cash
a. Authorised capital	a. Cash on hand
b. Issued capital	b. Cash with central bank and other banks
c. Subscribed capital	
d. Paid-up-capital	
2. Reserve fund	2. Money at call and short notice
3. Deposits	3. Bills discounted
4. Borrowings from other banks	4. Bills for collection
5. Bills payable	5. Investments
6. Acceptances and endorsements	6. Loans and advances
7. Contingent liabilities	7. Acceptances and endorsement
8. Profit and loss account	8. Fixed assets
9. Bills for collection	

Liabilities

Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank. Now we have to analyse the various items on the liabilities side.

1. **Capital:** The bank has to raise capital before commencing its business. Authorised capital is the maximum capital upto which the bank is empowered to raise capital by the Memorandum of Association. Generally, the entire authorised capital is not raised from the public. That part of authorised capital which is issued in the form of shares for public subscription is called the issued capital. Subscribed capital represents that part of issued capital which is actually subscribed by the public. Finally, paid-up capital is that part of the subscribed capital which the subscribers are actually called upon to pay.
2. **Reserve Fund:** Reserve fund is the accumulated undistributed profits of the bank. The bank maintains reserve fund to tide over any crisis. But, it belongs to the shareholders and hence a liability on the bank. In India, the commercial bank is required by law to transfer 20 per cent of its annual profits to the Reserve fund.
3. **Deposits:** The deposits of the public like demand deposits, savings deposits and fixed deposits constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can instill in the minds of the depositors. The bank can never afford to forget the claims of the depositors. Hence, the bank should always have enough cash to honour the obligations of the depositors.
4. **Borrowings from Other Banks:** Under this head, the bank shows those loans it has taken from other banks. The bank takes loans from other banks, especially the central bank, in certain extraordinary circumstances.
5. **Bills Payable:** These include the unpaid bank drafts and telegraphic transfers issued by the bank. These drafts and telegraphic transfers are paid to the holders thereof by the bank's branches, agents and correspondents who are reimbursed by the bank.
6. **Acceptances and Endorsements:** This item appears as a contra item on both the sides of the balance sheet. It represents the liability of the bank in respect of bills accepted or endorsed on behalf of its customers and also letters of credit issued and guarantees given on their behalf. For rendering this service, a commission is charged and the customers to whom this service is extended are liable to the bank for full payment of the bills. Hence, this item is shown on both sides of the balance sheet.
7. **Contingent Liabilities:** Contingent liabilities comprise of those liabilities which are not known in advance and are unforeseeable. Every bank makes some provision for contingent liabilities.
8. **Profit and Loss Account:** The profit earned by the bank in the course of the year is shown under this head. Since the profit is payable to the shareholders it represents a liability on the bank.
9. **Bills for Collection:** This item also appears on both the sides of the balance sheet. It consists of drafts and hundies drawn by sellers of goods on their customers and are sent to the bank for collection, against delivery documents like railway receipt, bill of lading, etc., attached thereto. All such bills in hand at the date of the balance sheet are shown on both the sides of the balance sheet because they form an asset of the

bank, since the bank will receive payment in due course, it is also a liability because the bank will have to account for them to its customers.

Assets

According to Crowther, the assets side of the balance sheet is more complicated and interesting. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank. The most important guiding principles of the distribution of assets of the bank are liquidity, profitability and safety or security. In fact, the various items on the assets side are distributed according to the descending order of liquidity and the ascending order of profitability.

Now, we have to analyse the various items on the assets side.

1. **Cash:** Here we can distinguish cash on hand from cash with central bank and other banks cash on hand refers to cash in the vaults of the bank. It constitutes the most liquid asset which can be immediately used to meet the obligations of the depositors. Cash on hand is called the first line of defence to the bank.

   In addition to cash on hand, the bank also keeps some money with the central bank or other commercial banks. This represents the second line of defence to the bank.
2. **Money at Call and Short Notice:** Money at call and short notice includes loans to the brokers in the stock market, dealers in the discount market and to other banks. These loans could be quickly converted into cash and without loss, as and when the bank requires. At the same time, this item yields income to the bank. The significance of money at call and short notice is that it is used by the banks to effect desirable adjustments in the balance sheet. This process is called 'Window Dressing'. This item constitutes the 'third line of defence' to the bank.
3. **Bills Discounted:** The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. These short term bills are highly negotiable and they satisfy the twin objectives of liquidity and profitability. If a commercial bank requires additional funds, it can easily rediscount the bills in the bill market and it can also rediscount the bills with the central bank.
4. **Bills for Collection:** As mentioned earlier, this item appears on both sides of the balance sheet.
5. **Investments:** This item includes the total amount of the profit yielding assets of the bank. The bank invests a part of its funds in government and non-government securities.
6. **Loans and Advances:** Loans and advances constitute the most profitable asset to the bank. The very survival of the bank depends upon the extent of income it can earn by advancing loans. But, this item is the least liquid asset as well. The bank earns quite a sizeable interest from the loans and advances it gives to the private individuals and commercial firms.

7. **Acceptances and Endorsements:** As discussed earlier, this item appears as a contra item on both sides of the balance sheet.
8. **Fixed Assets:** Fixed assets include building, furniture and other property owned by the bank. This item includes the total volume of the movable and immovable property of the bank. Fixed assets are referred to as 'dead stocks'. The bank generally undervalues this item deliberately in the balance sheet. The intention here is to build up secret reserves which can be used at times of crisis.

   Balance sheet of a bank acts as a mirror of its policies, operations and achievements. The liabilities indicate the sources of its funds; the assets are the various kinds of debts incurred by a bank to its customers. Thus, the balance sheet is a complete picture of the size and nature of operations of a bank.

CREDIT CREATION

An important function performed by the commercial banks is the creation of credit. The process of banking must be considered in terms of monetary flows, that is, continuous depositing and withdrawal of cash from the bank. It is only this activity which has enabled the bank to manufacture money. Therefore the banks are not only the purveyors of money but manufacturers of money.

Basis of Credit Creation

The basis of credit money is the bank deposits. The bank deposits are of two kinds viz., (1) Primary deposits, and (2) Derivative deposits.

1. **Primary Deposits:** Primary deposits arise or formed when cash or cheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called "primary deposits" or "cash deposits." It is out of these primary deposits that the bank makes loans and advances to its customers. The initiative is taken by the customers themselves. In this case, the role of the bank is passive. So these deposits are also called "passive deposits." These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.
2. **Derivative Deposits:** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called "derivative deposits." Since the bank play an active role in the creation of such deposits, they are also known as "active deposits." When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. The bank does not pay him cash. The customer is free to withdraw the amount whenever he wants by cheques. Thus the banker lends money in the form

of deposit credit. The creation of a derivative deposit does result in a net increase in the total supply of money in the economy, Hartly Withers says "every loan creates a deposit." It may also be said "loans make deposits" or "loans create deposits." It is rightly said that "deposits are the children of loans, and credit is the creation of bank clerk's pen."

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank discounts a bill or purchase government securities. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus asset acquired by a bank creates an equivalent bank deposit. It is perfectly correct to state that "bank loans create deposits." The derivate deposits are regarded as bank money or credit. Thus the power of commercial banks to expand deposits through loans, advances and investments is known as "credit creation."

Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as "the expansion of bank deposits through the process of more loans and advances and investments."

Process of Credit Creation

An important aspect of the credit creating function of the commercial banks is the process of multiple-expansion of credit. The banking system as a whole can create credit which is several times more than the original increase in the deposits of a bank. This process is called the multiple-expansion or multiple-creation of credit. Similarly, if there is withdrawal from any one bank, it leads to the process of multiple-contraction of credit. The process of multiple credit-expansion can be illustrated by assuming

(a) The existence of a number of banks, A, B, C etc., each with different sets of depositors.
(b) Every bank has to keep 10% of cash reserves, according to law, and,
(c) A new deposit of Rs. 1,000 has been made with bank A to start with.

Suppose, a person deposits Rs. 1,000 cash in Bank A. As a result, the deposits of bank A increase by Rs. 1,000 and cash also increases by Rs. 1,000. The balance sheet of the bank is as fallows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
New deposit	1,000	New Cash	1,000
Total	1,000		1,000

Under the double entry system, the amount of Rs. 1,000 is shown on both sides. The deposit of Rs. 1,000 is a liability for the bank and it is also an asset to the bank. Bank A has to keep only 10 % cash reserve, i.e., Rs. 100 against its new deposit and it has a surplus of Rs. 900 which it can profitably employ in the assets like loans. Suppose bank A gives a loan to X, who uses the amount to pay off his creditors. After the loan has been made and the amount so withdrawn by X to pay off his creditors, the balance sheet of bank A will be as follows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
Deposit	1,000	New Cash	100
		Loan to X	900
Total	1,000		1,000

Suppose X purchase goods of the value of Rs. 900 from Y and pay cash. Y deposits the amount with Bank B. The deposits of Bank B now increase by Rs. 900 and its cash also increases by Rs. 900. After keeping a cash reserve of Rs. 90, Bank B is free to lend the balance of Rs. 810 to any one. Suppose bank B lends Rs. 810 to Z, who uses the amount to pay off his creditors. The balance sheet of bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Rs.	Assets	Rs.
Deposit	900	Cash Loan to Z	90 810
Total	900		900

Suppose Z purchases goods of the value of Rs. 810 from S and pays the amount. S deposits the amount of Rs. 810 in bank C. Bank C now keeps 10 % as reserve (Rs. 81) and lends Rs. 729 to a merchant. The balance sheet of bank C will be as follows:

Balance Sheet of Bank C

Liabilities	Rs.	Assets	Rs.
Deposit	810	Cash	81
		Loan	729
Total	810		810

Thus looking at the banking system as a whole, the position will be as follow:

Name of bank	Deposits Rs.	Cash reserve Rs.	Loan Rs.
Bank A	1,000	100	900
Bank B	900	90	810
Bank C	810	81	729
Total	2,710	271	2,439

It is clear from the above that out of the initial primary deposit, bank advanced Rs. 900 as a loan. It formed the primary deposit of bank B, which in turn advanced Rs. 810 as loan. This sum again formed, the primary deposit of bank C, which in turn advanced Rs. 729 as loan. Thus the inital primary deposit of Rs. 1,000 resulted in bank credit of Rs. 2439 in three banks. There will be many banks in the country and the above process of credit expansion will come to an end when no bank has an excess reserve to lend. In the above example, there will be 10 fold increase in credit because the cash ratio is 10%. The total volume of credit created in the banking system depends on the cash ratio. If the cash ratio is 10% there will be 10 fold increase. If it is 20%, there will be 5 fold increase. When the banking system receives an additional primary deposit, there will be multiple expansion of credit. When the banking system loses cash, there will be multiple contraction of credit.

The extent to which the banks can create credit together could be found out with the help of the credit multiplier formula. The formula is:

$$K = \frac{1}{r}$$

Where K is the credit multiplier, and r, the required reserves. If the reserve ratio is 10% the size of credit multiplier will be:

$$K = \frac{1}{r} = \frac{1}{0.1} = 10$$

It means that the banking system can create credit together which is ten times more than the original increase in the deposits. It should be noted here that the size of credit multiplier is inversely related to the percentage of cash reserves the banks have to maintain. If the reserve ratio increases, the size of credit multiplier is reduced and if the reserve ratio is reduced, the size of credit multiplier will increase.

Leaf and Cannon Criticism

Walter Leaf and Edwin Cannon objected to the theory of credit creation. According to them, the commercial bank cannot lend anything more than what it receives as cash from deposits. But the contention of Leaf and Cannon that banks cannot create credit is wrong due to the following reasons:

(a) A single bank may not be able to create derivative deposits in excess of its cash reserves. But the banking system as a whole can do what a single bank cannot do.

(b) As Crowther points out that the total net deposits of commercial banks are for in excess of their cash reserves. It means they can create credit.

Limitation on Credit Creation

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

1. **Amount of Cash:** The power to create credit depends on the cash received by banks. If banks receive more cash, they can create more credit. If they receive less cash they can create less credit. Cash supply is controlled by the central bank of the country.
2. **Cash Reserve Ratio:** All deposits cannot be used for credit creation. Banks must keep certain percentage of deposits in cash as reserve. The volume of bank credit depends also on the cash reserve ratio the banks have to keep. If the cash reserve ratio is increased, the volume of credit that the banks can create will fall. If the cash reserve ratio is lowered, the bank credit will increase. The Central Bank has the power to prescribe and change the cash reserve ratio to be kept by the commercial banks. Thus the central bank can change the volume of credit by changing the cash reserve ratio.
3. **Banking Habits of the People:** The loan advanced to a customer should again come back into banks as primary deposit. Then only there can be multiple expansion. This will happen only when the banking habit among the people is well developed. They should keep their money in the banks as deposits and use cheques for the settlement of transactions.
4. **Nature of Business Conditions in the Economy:** Credit creation will depend upon the nature of business conditions. Credit creation will be large during a period of prosperity, while it will be smaller during a depression. During periods of prosperity, there will be more demand for loans and advances for investment purposes. Many people approach banks for loans and advances. Hence, the volume of bank credit will be high. During periods of business depression, the amount of loans and advances will be small because businessmen and industrialists may not come to borrow. Hence the volume of bank credit will be low.
5. **Leakages in Credit-Creation:** There may be some leakages in the process of credit creation. The funds may not flow smoothly from one bank to another. Some people may keep a portion of their amount as idle cash.
6. **Sound Securities:** A bank creates credit in the process of acquiring sound and profitable assets, like bills, and government securities. If people cannot offer sound securities, a bank cannot create credit. Crowther says “a bank cannot create money out of thin air. It transmutes other forms of wealth into money.”
7. **Liquidity Preference:** If people desire to hold more cash, the power of banks to create credit is reduced.
8. **Monetary Policy of the Central Bank:** The extent of credit creation will largely depend upon the monetary policy of the Central Bank of the country. The Central Bank has the power to influence the volume of money in circulation and through this it can influence the volume of credit created by the banks. The Central Bank has also certain powerful weapons, like the bank rate, open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial bank.

Thus, the ability of the bank to create credit is subject to various limitations. Still, one should not undermine the importance of the function of credit creation of the banks. This function has far-reaching effect on the working of the economy, especially on the business activity. Bank credit is the oil which lubricates the wheels of the business machine.

UNIT BANKING VS BRANCH BANKING

The banking system in different countries vary substantially from one another. Broadly speaking, however, there are two important types of banking systems, viz., unit banking and branch banking.

A. Unit Banking

'Unit banking' means a system of banking under which banking services are provided by a single banking organisation. Such a bank has a single office or place of work. It has its own governing body or board of directors. It functions independently and is not controlled by any other individual, firm or body corporate. It also does not control any other bank. Such banks can become member of the clearing house and also of the Banker's Association. Unit banking system originated and grew in the U.S.A. Different unit banks in the U.S.A. are linked with each other and with other financial centres in the country through "correspondent banks."

Advantages of Unit Banking

Following are the main advantages of unit banking:

1. **Efficient Management:** One of the most important advantages of unit banking system is that it can be managed efficiently because of its size and work. Co-ordination and control becomes effective. There is no communication gap between the persons making decisions and those executing such decisions.
2. **Better Service:** Unit banks can render efficient service to their customers. Their area of operation being limited, they can concentrate well on that limited area and provide best possible service. Moreover, they can take care of all banking requirements of a particular area.
3. **Close Customer-banker Relations:** Since the area of operation is limited the customers can have direct contact. Their grievances can be redressed then and there.
4. **No Evil Effects Due to Strikes or Closure:** In case there is a strike or closure of a unit, it does not have much impact on the trade and industry because of its small size. It does not affect the entire banking system.
5. **No Monopolistic Practices:** Since the size of the bank and area of its operation are limited, it is difficult for the bank to adopt monopolistic practices. Moreover, there is free competition. It will not be possible for the bank to indulge in monopolistic practices.

6. **No Risks of Fraud:** Due to small size of the bank, there is stricter and closer control of management. Therefore, the employees will not be able to commit fraud.
7. **Closure of Inefficient Banks:** Inefficient banks will be automatically closed as they would not be able to satisfy their customers by providing efficient service.
8. **Local Development:** Unit banking is localised banking. The unit bank has the specialised knowledge of the local problems and serves the requirement of the local people in a better manner than branch banking. The funds of the locality are utilised for the local development and are not transferred to other areas.
9. **Promotes Regional Balance:** Under unit banking system, there is no transfer of resources from rural and backward areas to the big industrial and commercial centres. This tends to reduce regional imbalance.

Disadvantages of Unit Banking

1. **No Economies of Large Scale:** Since the size of a unit bank is small, it cannot reap the advantages of large scale viz., division of labour and specialisation.
2. **Lack of Uniformity in Interest Rates:** In unit banking system there will be large number of banks in operation. There will be lack of control and therefore their rates of interest would differ widely from place to place. Moreover, transfer of funds will be difficult and costly.
3. **Lack of Control:** Since the number of unit banks is very large, their co-ordination and control would become very difficult.
4. **Risks of Bank's Failure:** Unit banks are more exposed to closure risks. Bigger unit can compensate their losses at some branches against profits at the others. This is not possible in case of smaller banks. Hence, they have to face closure sooner or later.
5. **Limited Resources:** Under unit banking system the size of bank is small. Consequently its resources are also limited. Hence, they cannot meet the requirements of large scale industries.
6. **Unhealthy Competition:** A number of unit banks come into existence at an important business centre. In order to attract customers they indulge in unhealthy competition.
7. **Wastage of National Resources:** Unit banks concentrate in big metropolitan cities whereas they do not have their places of work in rural areas. Consequently there is uneven and unbalanced growth of banking facilities.
8. **No Banking Development in Backward Areas:** Unit banks, because of their limited resources, cannot afford to open uneconomic branches in smaller towns and rural areas. As such, these areas remain unbanked.
9. **Local Pressure:** Since unit banks are highly localised in their business, local pressures and interferences generally disrupt their normal functioning.

B. Branch Banking System

It means a system of banking in which a banking organisation works at more than one place. The main place of business is called head office and the other places of business are called branches. The head office controls and co-ordinates the work at branches. The day-to-day operations are performed by the branch manager as per the policies and directions issued from time to time by the head office.

This system of banking is prevalent throughout the world. In India also, all the major banks have been operating under branch banking system.

Advantages of Branch Banking

1. **Better Banking Services:** Such banks, because of their large size can enjoy the economies of large scale viz., division of work and specialisation. These banks can also afford to have the specialised services of bank personnel which the unit banks can hardly afford.
2. **Extensive Service:** Branch banking can provide extensive service to cover large area. They can open their branches throughout the country and even in foreign countries.
3. **Decentralisation of Risks:** In branch banking system branches are not concentrated at one place or in one industry. These are decentralised at different places and in different industries. Hence the risks are also distributed.
4. **Uniform Rates of Interest:** In branch banking, there is better control and co-ordination of the central bank. Consequently interest rates can be uniform.
5. **Better Cash Management:** In branch banking there can be better cash management as cash easily be transferred from one branch to another. Therefore, there will be lesser need to keep the cash idle for meeting contingencies.
6. **Better Training Facilities to Employees:** Under branch banking the size of the bank is quite large. Therefore, such banks can afford to provide better training facilities to their employees. Almost every nationalised bank in India has its separate training college.
7. **Easy and Economical Transfer of Funds:** Under branch banking, a bank has a widespread of branches. Therefore, it is easier and economical to transfer funds from one branch to the other.
8. **Better Investment of Funds:** Such bank can afford the services of specialised and expert staff. Therefore they invest their funds in such industries where they get the highest return and appreciation without sacrificing the safety and liquidity of funds.
9. **Effective Central Bank Control:** Under branch banking, the central bank has to deal only with a few big banks controlling a large number of branches. It is always easier and more convenient to the central bank to regulate and control the credit policies of a few big banks, than to regulate and control the activities of a large number of small unit banks. This ensures better implementation of monetary policy.

10. **Contacts with the Whole Country:** Under branch banking, the bank maintains continual contacts with all parts of the country. This helps it to acquire correct and reliable knowledge about economic conditions in various parts of the country. This knowledge enables the bank to make a proper and profitable investment of its surplus funds.
11. **Greater Public Confidence:** A bank, with huge financial resources and number of branches spread throughout the country, can command greater public confidence than a small unit bank with limited resources and one or a few branches.

Disadvantages of Branch Banking

Following are the disadvantages of branch banking:

1. **Difficulties of Management, Supervision and Control:** Since there are hundreds of branches of a bank under this system, management, supervision and control became more inconvenient and difficult. There are possibilities of mismanagement in branches. Branch managers may misuse their position and misappropriate funds. There is great scope for fraud. Thus there are possibilities of fraud and irregularities in the financial management of the bank.
2. **Lack of Initiative:** The branches of the bank under this system suffer from a complete lack of initiative on important banking problems confronting them. No branch of the bank can take decision on important problems without consulting the head office. Consequently, the branches of the bank find themselves unable to carry on banking activities in accordance with the requirements of the local situation. This makes the banking system rigid and inelastic in its functioning. This also leads to "red-tapism" which means "official delay."
3. **Monopolistic Tendencies:** Branch banking encourages monopolistic tendencies in the banking system. A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources in the hands of a small number of men. Such a monopoly power is a source of danger to the community, whose goal is a socialistic pattern of society.
4. **Regional Imbalances:** Under the branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the country.
5. **Continuance of Non-profitable Branches:** Under branch banking, the weak and unprofitable branches continue to operate under the protection cover of the stronger and profitable branches.
6. **Unnecessary Competition:** Branch banking is delocalised banking, under branch banking system, the branches of different banks get concentrated at certain places, particularly in big towns and cities. This gives rise to unnecessary and unhealthy competition among them. The branches of the competing banks try to tempt customers by offering extra inducements and facilities to them. This naturally increases the banking expenditure.

7. **Expensiveness:** Branch banking system is much more expensive than the unit banking system. When a bank opens a number of branches at different places, then there arises the problem of co-ordinating their activities with others. This necessitates the employment of expensive staff by the bank.
8. **Losses by Some Branches Affect Others:** When some branches suffer losses due to certain reasons, this has its repercussions on other branches of the bank.

   Thus branch banking system as well as unit banking system suffer from defects and drawbacks. But the branch banking system is, on the whole, better than the unit banking system. In fact, the branch banking system has proved more suitable for backward and developing countries like India. Branch banking is very popular and successful in India. A comparison between unit banking and branch banking is essentially a comparison between small-scale and large-scale operations.

COMMERCIAL BANKS AND ECONOMIC DEVELOPMENT

Commercial banks are considered not merely as dealers in money but also the leaders in economic development. They are not only the store houses of the country's wealth but also the reservoirs of resources necessary for economic development. They play an important role in the economic development of a country. A well-developed banking system is essential for the economic development of a country. The "Industrial Revolution" in Europe in the 19th century would not have been possible without a sound system of commercial banking. In case of developing countries like India, the commercial banks are considered to be the backbone of the economy. Commercial banks can contribute to a country's economic development in the following ways :

1. **Accelerating the Rate of Capital Formation:** Capital formation is the most important determinant of economic development. The basic problem of a developing economy is slow rate of capital formation. Banks promote capital formation. They encourage the habit of saving among people. They mobilise idle resources for production purposes. Economic development depends upon the diversion of economic resources from consumption to capital formation. Banks help in this direction by encouraging saving and mobilising them for productive uses.
2. **Provision of Finance and Credit:** Commercial banks are a very important source of finance and credit for industry and trade. Credit is a pillar of development. Credit lubricates all commerce and trade. Banks become the nerve centre of all commerce and trade. Banks are instruments for developing internal as well as external trade.
3. **Monetisation of Economy:** An underdeveloped economy is characterised by the existence of a large non-monetised sector. The existence of this non-monetised sector is a hindrance in the economic development of the country. The banks, by opening branches in rural and backward areas can promote the process of monetisation (conversion of debt into money) in the economy.

4. **Innovations:** Innovations are an essential prerequisite for economic development. These innovations are mostly financed by bank credit in the developed countries. But in underdeveloped countries, entrepreneurs hesitate to invest in new ventures and undertake innovations largely due to lack of funds. Facilities of bank loans enable the entrepreneurs to step up their investment on innovational activities, adopt new methods of production and increase productive capacity of the economy.
5. **Implementation of Monetary Policy:** Economic development need an appropriate monetary policy. But a well-developed banking is a necessary pre-condition for the effective implementation of the monetary policy. Control and regulation of credit by the monetary authority is not possible without the active co-operation of the banking system in the country.
6. **Encouragement to Right Type of Industries:** Banks generally provide financial resources to the right type of industries to secure the necessary material, machines and other inputs. In this way they influence the nature and volume of industrial production.
7. **Development of Agriculture:** Underdeveloped economies are primarily agricultural economies. Majority of the population in these economies live in rural areas. Therefore, economic development in these economies requires the development of agriculture and small scale industries in rural areas. So far banks in underdeveloped countries have been paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must provide loans to agriculture for development and modernisation of agriculture. In recent years, the State Bank of India and other commercial banks are granting short term, medium-term and long-term loans to agriculture and small-scale industries.
8. **Regional Development:** Banks can also play an important role in achieving balanced development in different regions of the country. They transfer surplus capital from the developed regions to the less developed regions, where it is scarce and most needed. This reallocation of funds between regions will promote economic development in underdeveloped areas of the country.
9. **Promote Industrial Development:** Industrial development needs finance. In some countries, commercial banks encouraged industrial development by granting long-term loans also. Loan or credit is a pillar to development. In underdeveloped countries like India, commercial banks are granting short-term and medium-term loans to industries. They are also underwriting the issue of shares and debentures by industrial concerns. This helps industrial concerns to secure adequate capital for their establishment, expansion and modernisation. Commercial banks are also helping manufacturers to secure machinery and equipment from foreign countries under instalment system by guaranteeing deferred payments. Thus, banks promote or encourage industrial development.

10. **Promote Commercial Virtues:** The businessmen are more afraid of a banker than a preacher. The businessmen should have certain business qualities like industry, forethought, honesty and punctuality. These qualities are called "commercial virtues" which are essential for rapid economic progress. The banker is in a better position to promote commercial virtues. Banks are called "public conservators of commercial virtues."
11. **Fulfillment of Socio-economic Objectives:** In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state. For example, nationalised bank in India have framed special innovative schemes of credit to help small agriculturists, self-employed persons and retailers through loans and advances at concessional rates of interest. Banking is thus used to achieve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

Thus, banks in a developing country have to play a dynamic role. Economic development places heavy demand on the resources and ingenuity of the banking system. It has to respond to the multifarious economic needs of a developing country. Traditional views and methods may have to be discarded. "An Institution, such as the banking system, which touches and should touch the lives of millions, has necessarily to be inspired by a larger social purpose and has to subserve national priorities and objectives." A well-developed banking system provides a firm and durable foundation for the economic development of the country.

Conclusion

From the above discussion, undoubtedly, we can say that, commercial banks form the most important part of financial intermediaries. It accepts deposits from the general public and extends loans to the households, firms and the government. Banks form a significant part of the infrastructure essential for breaking vicious circle of poverty and promoting economic growth.

Questions for Discussion

1. What is a commercial bank? What are the main functions performed by commercial banks? How far are they useful for economic development?
2. State the kinds of commercial banks.
3. What do you understand by a commercial bank's balance sheet? What specific information does it convey?
4. What is the investment policy of a commercial bank? Explain the factors that constitute for formulating a suitable investment policy.
5. What is credit creation? How banks create credit? What are the limitations of credit creation?
6. State the advantages and disadvantages of unit banking system.
7. State the advantages and disadvantages of branch banking system.
8. Discuss the role of banks in a developing economy.

2

CENTRAL BANKING

INTRODUCTION

A central bank is an 'apex institution' in the banking structure of a country. It supervises, controls and regulates the activities of commercial banks and acts as a banker to them. It also acts as a banker, agent and adviser to the government in all financial and monetary matters. A central bank is also the custodian of the foreign balances of the country and is responsible to maintain the rate of exchange fixed by the government and manages exchange control. The most important function of a central bank is to regulate the volume of currency and credit in a country. It will be no exaggeration to say that a modern central bank is the central arch to the monetary and fiscal framework in almost all the countries developed or developing in the world. In developing economies, the central bank has also to perform certain promotional and developmental functions to accelerate the pace of economic growth.

Meaning of Central Bank

In every country there is one bank which acts as the leader of the money market, supervising, controlling and regulating the activities of commercial banks and other financial institutions. It acts as a bank of issue and is in close touch with the government, as banker, agent and adviser to the latter. Such a bank is known as the **central bank** of the country.

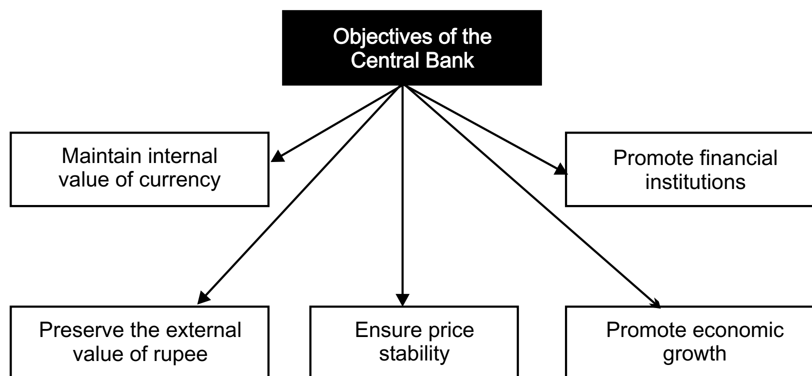
Definition of Central Bank

A banking institution can more easily be identified by the functions that it performs. According to Vera Smith, "the primary definition of central banking is a banking system in which a single bank has either a complete or residuary monopoly in the note issue." Kisch and Elkin believe that "the essential function of a central bank is the maintenance of the stability of the monetary standard." In the statutes of the Bank for International Settlements a central bank is defined as "the bank of the country to which has been entrusted the duty

of regulating the volume of currency and credit in that country." De Kock gives a very comprehensive definition of central bank. According to De Kock, a central bank is a bank which constitutes the apex of the monetary and banking structure of its country and which performs, best it can in the national economic interest, the following functions:

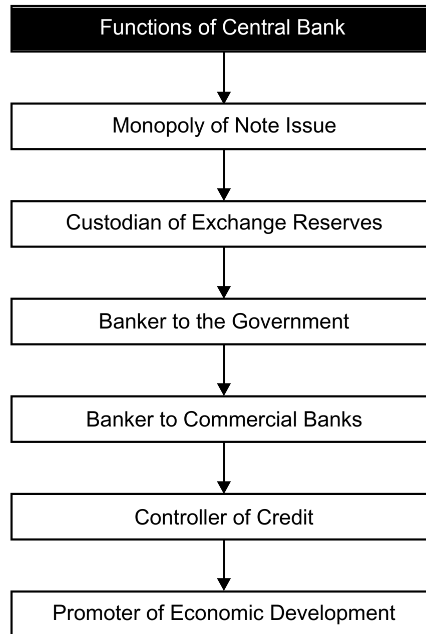
(a) The regulation of currency in accordance with the requirements of business and the general public, for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof.
(b) The performance of general banking and agency services for the state.
(c) The custody of cash reserves of the commercial banks.
(d) The custody and management of the nation's reserves of international currency.
(e) The granting of accommodation, in the form of rediscounts, or collateral advances, to commercial banks, bill brokers and dealers, or other financial institutions, and the general acceptance of the responsibility of lender of last resort.
(f) The settlement of clearances between the banks.
(g) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state.

The nature of function of a central bank differs in a developed economy as compared to those in a developing economy.



Functions of the Central Bank

The functions of the central bank differ from country to country in accordance with the prevailing economic situation. But there are certain functions which are commonly performed by the central bank in all countries. According to De Kock, there are six functions which are performed by the central bank in almost all countries.



1. **Monopoly of Note Issue:** The issue of money was always the prerogative of the government. Keeping the minting of coins with itself, the government delegated the right of printing currency notes to the central bank. In fact the right and privilege of note issue was always associated with the origin and development of central banks which were originally called as banks of issue. Nowadays, central banks everywhere enjoy the exclusive monopoly of note issue and the currency notes issued by the central banks are declared unlimited legal tender throughout the country. At one time, even commercial banks could issue currency notes but there were certain evils in such a system such as lack of uniformity in note issue, possibility of over-issue by individual banks and profits of note issue being enjoyed only by a few private shareholders. But concentration of note issue in the central bank brings about uniformity in note issue, which, in turn, facilitates trade and exchange within the country, attaches distinctive prestige to the currency notes, enables the central bank to influence and control the credit creation of commercial banks, avoids the over-issue of notes and, lastly, enables the government to appropriate partly or fully the profits of note issue. The central bank keeps three considerations in view as regards issue of notes-uniformity, elasticity (amount according to the need for money), and safety.
2. **Custodian of Exchange Reserves:** The central bank holds all foreign exchange reserves-key currencies such as U.S. dollars, British pounds and other prominent currencies, gold stock, gold bullion, and other such reserves-in its custody. This right of the central bank enables it to exercise a reasonable control over foreign exchange, for example, to maintain the country's international liquidity position at

a safe margin and to maintain the external value of the country's currency in terms of key foreign currencies.

3. **Banker to the Government:** Central banks everywhere perform the functions of banker, agent and adviser to the government. As a banker to the government, the central bank of the country keeps the banking accounts of the government both of the Centre and of the States performs the same functions as a commercial bank ordinarily does for its customers. As a banker and agent to the government, the central bank makes and receives payments on behalf of the government. It helps the government with short-term loans and advances (known as ways and means advances) to tide over temporary difficulties and also floats public loans for the government. It also manages the public debt (i.e., floats services and redeems government loans). It advises the government on monetary and economic matters.
4. **Banker to Commercial Banks:** Broadly speaking, the central bank acts as the banker's bank in three different capacities: (a) It acts as the custodian of the cash reserves of the commercial banks (b) It acts as the lender of the last resort (c) It is the bank of central clearance, settlement and transfer. We shall now discuss these three functions one by one.
   (a) *It acts as the custodian of the cash reserves of commercial banks:* Commercial banks keep part of their cash balances as deposits with the central bank of a country known as centralisation of cash reserves. Part of these balances are meant for clearing purposes, that is, payment by one bank to another will be simple book entry adjustment in the books of the central bank. There are many advantages when all banks keep part of their cash reserves with the central bank of the country. In the first place, with the same amount of cash reserves, a large amount of credit creation is possible. Secondly, centralised cash reserves will enable commercial banks to meet crises and emergencies. Thirdly, it enables the central bank to provide additional funds to those banking institutions which are in temporary difficulties. Lastly, it enables the central bank to influence and control the credit creation of commercial banks by making the cash reserves of the latter more or less.
   (b) *Lender of the last resort:* As the banker's bank, the central bank can never refuse to accommodate commercial banks. Any commercial bank wanting accommodation from the central bank can do so by rediscounting (selling) eligible securities with the central bank or can borrow from the central bank against eligible securities. By lender of the last resort, it is implied that the latter assumes the responsibility of meeting directly or indirectly all reasonable demands for accommodation by commercial banks in times of difficulties and crisis.
   (c) *Clearing agent:* As the central bank becomes the custodian of cash reserves of commercial banks, it is but logical for it to act as a settlement bank or a clearing house for other banks. As all banks have their accounts with the central bank, the claims of banks against each other are settled by simple transfers from and

to their accounts. This method of settling accounts through the central bank, apart from being convenient, is economical as regards the use of cash. Since claims are adjusted through accounts, there is usually no need for cash. It also strengthens the banking system by reducing withdrawals of cash in times of crisis. Furthermore, it keeps the central bank of informed about the state of liquidity of commercial banks in regard to their assets.

5. **Controller of Credit:** Probably the most important of all the functions performed by a central bank is that of controlling the credit operations of commercial banks. In modern times, bank credit has become the most important source of money in the country, relegating coins and currency notes to a minor position. Moreover, it is possible, as we have pointed out in a previous chapter, for commercial banks to expand credit and thus intensify inflationary pressure or contract credit and thus contribute to a deflationary situation. It is, thus, of great importance that there should be some authority which will control the credit creation by commercial banks. As controller of credit, the central bank attempts to influence and control the volume of bank credit and also to stabilise business conditions in the country.
6. **Promoter of Economic Development:** In developing economies the central bank has to play a very important part in the economic development of the country. Its monetary policy is carried out with the object of serving as an instrument of planned economic development with stability. The central bank performs the function of developing long-term financial institutions, also known as development banks, to make available adequate investible funds for the development of agriculture, industry, foreign trade, and other sectors of the economy. The central bank has also to develop money and capital markets.

   In addition, the central bank may also undertake miscellaneous functions such as providing assistance to farmers through co-operative societies by subscribing to their share capital, promoting finance corporations with a view to providing loans to large-scale and small-scale industries and publishing statistical reports on tends in the money and capital markets. In short, a central bank is an institution which always works in the best economic interests of the nation as a whole. In view of all these functions, as discussed above, it follows that a modern central bank is much more than a Bank of Issue.

CREDIT CONTROL

It means the regulation of the creation and contraction of credit in the economy. It is an important function of central bank of any country. The importance of credit control has increased because of the growth of bank credit and other forms of credit. Commercial banks increase the total amount of money in circulation in the country through the mechanism of credit creation. In addition, businessmen buy and sell goods and services on credit basis. Because of these developments, most countries of the world are based on credit economy rather than money economy.

Fluctuations in the volume of credit cause fluctuations in the purchasing power of money. This fact has far reaching economic and social consequences. That is why, credit control has become an important function of any central bank. For instance, the preamble to the Bank of Canada Act states that the Bank of Canada will regulate credit in Canada. In India, the Reserve Bank has been given wide powers to control credit creation and contraction by commercial banks. Before we discuss the techniques of credit control, it is desirable to understand the objectives of credit control.

Objectives of Credit Control

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

(a) *Stability of Internal Price-level:* The commercial bank can create credit because their main task is borrowing and lending. They create credit without any increase in cash with them. This leads to increase in the purchasing power of many people which may lead to an increase in the prices. The central bank applies its credit control to bring about a proper adjustment between the supply of credit and measures requirements of credit in the country. This will help in keeping the prices stable.

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

(c) *Promotion of Economic Development:* The objective of credit control should be to promote economic development and employment in the country. When there is lack of money, its supply should be increased so that there are more and more economic activities and more and more people may get employment. While resorting to credit squeeze, the central bank should see that these objectives are not affected adversely.

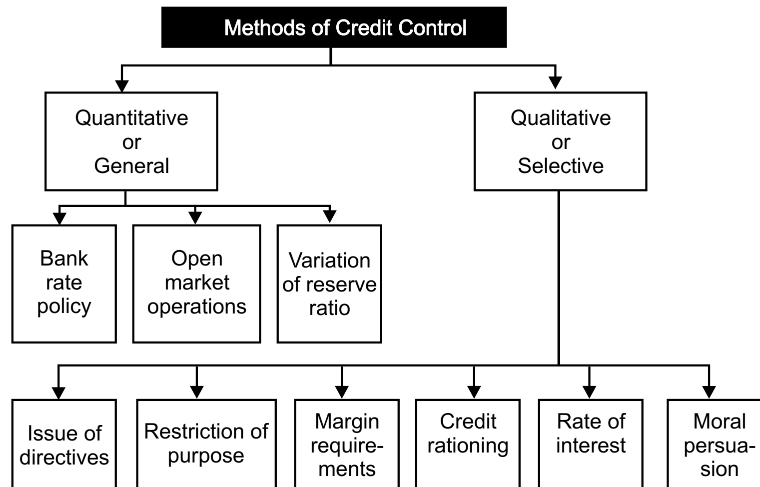
(d) *Stability of the Money Market:* The central bank should operate its weapons of credit control so as to neutralise the seasonal variations in the demand for funds in the country. It should liberalise credit in terms of financial stringencies to bring about stability in the money market.

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

Methods of Credit Control

The various methods employed by the central bank to control credit creation power of the commercial banks can be classified in two groups viz., quantitative controls, and qualitative

controls. Quantitative controls are designed to regulate the volume of credit created by the banking system. These measures work through influencing the demand and supply of credit. Quantitative measures, on the other hand, are designed to regulate the flow of credit in specific uses.



1. **Quantitative Methods:** Quantitative methods aim at controlling the total volume of credit in the country. They relate to the volume and cost of bank credit in general, without regard to the particular field of enterprise or economic activity in which the credit is used.

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

A. Bank Rate or Discount Rate Policy

Bank Rate Policy or the Discount Rate Policy has been the earliest instrument of quantitative credit control. It was the Bank of England which experimented with the bank rate policy for the first time as a technique of monetary management. Now every central bank has been endowed with this instrument of credit control.

Meaning

Bank rate refers to the official minimum lending rate of interest of the central bank. It is the rate at which the central bank advances loans to the commercial banks by rediscounting the approved first class bills of exchange of the banks. Hence, bank rate is also called as the discount rate.

Theory of Bank Rate

The theory underlying the operation of bank rate is that by manipulating the bank rate, the central bank is in a position to exercise influence upon the supply of credit in the economy. According to the theory of bank rate an increase or a decrease in the bank rate leads to a

reduction or an increase in the supply of credit in the economy. This is possible because changes in the bank rate bring about changes in the other rates of interest in the economy.

Working of Bank Rate

As mentioned above, by manipulating the bank rate it is possible to effect changes in the supply of credit in the economy. During a period of inflation, to arrest the rise in the price level, the central bank raises the bank rate. When the bank rate is raised, all other interest rates in the economy also go up. As a result, the commercial bank also raise their lending rates. The consequence is an increase in the cost of credit. This discourages borrowing and hence investment activity is curbed in the economy. This will bring about a reduction in the supply of credit and money in the economy and therefore in the level of prices.

On the other hand, during a period of deflation, the central bank will lower the bank rate in order to encourage business activity in the economy. When the bank rate is lowered, all other interest rates in the economy also come down. The banks increase the supply of credit by reducing their lending rates. A reduction in the bank rate stimulates investment and the fall in the price level is arrested.

The Process of Bank Rate Influence

Regarding the process through which changes in the bank rate influence the supply of credit, the level of business activity and the price level, we can distinguish two approaches. One put forth by R.G. Hawtrey and the other one associated with J.M. Keynes.

In the opinion of Hawtrey, changes in the bank rate operate through changes in the short term rates of interest. These changes in the short term interest rates, in their turn, influence the cost of borrowing by businessmen and industrialists.

But, according to Lord Keynes, changes in bank rate become effective through changes in the long term interest rates as reflected by changes in the capital value of long term securities.

But, it should be noted that there is not much difference between the two approaches and hence they are complementary to each other.

Bank Rate Under the Gold Standard

Under the gold standard, bank rate was used primarily to set right the disequilibrium in the balance of payments of the country. When there was a deficit in the balance of payments and hence an outflow of gold, bank rate was raised to check the outflow of gold. This was done by attracting the inflow of short term capital into the country.

Conditions for the Success of the Bank Rate Policy

The efficacy of bank rate as an instrument of monetary management calls for the fulfillment of the following conditions:

(a) *Close relationship between bank rate and other interest rates:* It is necessary that the relationship between bank rate and the other interest in the economy should be close and direct. Changes in the rate should bring about similar and appropriate changes in the other interest rates in the economy. Otherwise the efficacy of bank rate will be limited. There is, therefore, the need for the existence of an integrated interest rate structure.

(b) *Existence of an elastic economic system:* The success of bank rate requires the existence of an elastic economic structure. That is, the entire economic system should be perfectly flexible to accommodate itself to changes in the bank rate. Changes in the bank rate should bring about similar and desirable changes in prices, costs, wages, output, profits, etc. The existence of a rigid economic structure will reduce the efficacy of bank rate.

(c) *Existence of short term funds market:* Another condition required for the success of bank rate policy is the existence of market for short term funds in the country. This will help to handle foreign as well as domestic funds that come up on account of changes in the interest rates, following changes in the bank rate.

Before the First World War, bank rate policy was very effective as an instrument of quantitative credit control because, the conditions necessary for the success of bank rate were there. But, after the war, the significance of bank rate began to wane because the post-war atmosphere was not conducive for the smooth and effective operation of the bank rate policy.

Limitations

The Bank Rate Policy suffers from the following limitations:

(a) It has been argued that bank rate proves ineffective to combat boom and depression. During a period of boom, investment is interest inelastic. Even if the bank rate is raised to any extent, investment activity will not be curbed, because during a period of boom, the marginal efficiency of capital will be very high and the entire business community will be caught in a sweep of optimism. During depression, bank rate becomes ineffective following the general psychology of diffidence and pessimism among the business circles.

(b) The growth of non-banking financial intermediaries has proved an effective threat to the effectiveness of bank rate policy. It has been adequately established by the study of the Redcliffe Report and Gurley-Shaw, that the mushroom growth of non-banking financial intermediaries has belittled the significance of bank rate. This is because changes in the bank rate immediately affect the rates of interest of the commercial banks only and the non-banking financial institutions are not subject to the direct control of the central bank. Hence, it is said that **"the good boy is punished for the actions of a bad boy."**

(c) The decline in the use of bills of exchange as credit instruments also has been responsible for the decline in the importance of bank rate.

(d) Further, of late, businessmen have found out alternative methods of business financing, self-financing, ploughing back the profits, public deposits, etc. Indeed, the role of commercial banks as suppliers of loanable funds has been decreasing in importance.

(e) Moreover, the economic structure has not been adequately responding itself to changes in the bank rate. After the war, all kinds of rigidities have crept into the economic system.

(f) The invention of alternative instruments of credit control also has accounted for the decline in the popularity of bank rate.

(g) Further, the dependence of the commercial bank on the central bank for loans also has decreased leading to the decline in getting the bills of exchange rediscounted by the central bank. In addition, there has been an increased liquidity in the assets of banks.

(h) Finally, the increase in the importance of fiscal policy following the Great Depression of 1930's has also reduced the importance of bank take policy as a technique of credit control.

However, in spite of the above limitations that the bank rate policy is subject to, it would be wrong to undermine the significance of bank rate as a tool monetary management. Though, by itself, it may not yield the desirable results, but will certainly prove effective when used with other instruments of credit control. The scope for the use of bank rate by the central bank, therefore, cannot be completely ruled out. The bank rate has undergone a significant revival. Its significance in controlling inflation cannot be undermined.

B. Open Market Operations

After the First World War, bank rate policy as a tool of monetary management began to loose its significance following the invention of alternative techniques of credit control. Among the alternative instruments of quantitative credit control invented in the post-war period, open market operations assumed significance.

Meaning

Open market operations refer to the purchase and sale of securities by the central bank. In its broader sense, the term includes the purchase and sale of both government and private securities. But, in its narrow connotation, open market operations embrace the purchase and sale of government securities only. It was in Germany that open market operations took its birth as an instrument of quantitative credit control.

Theory of Open Market Operations

The theory underlying the operation of open market operations is that by the purchase and sale of securities, the central bank is in a position to increase or decrease the cash reserves of the commercial banks and therefore increase or decrease the supply of credit in the economy.

The modus operandi of open market operations can now be explained. During a period of inflation, the central bank seeks to reduce the supply of credit in the economy. Hence, it sells the securities to the banks, public and others. As a result of the sale of securities by the central bank, there will be a transfer of cash from the buyers to the central bank. This will reduce the cash reserves of the commercial banks. The public has to withdraw money from their accounts in the banks to pay for the securities purchased from the central bank. And the commercial banks themselves will have to transfer some amount to the central bank for having purchased the securities. All this shrinks the volume of cash in the vaults of the banks. As a result the banks will be unable to expand the supply of credit. When the supply of credit is reduced by the banking system, the consequences on the economy will be obvious. Investment activity is discouraged ultimately leading to a fall in the price level.

On the other hand, during a period of deflation, in order to inject more and more credit in to the economy, the central bank purchases the securities. This will have an encouraging effect on investment because the banks supply more credit following an increase in their cash reserves. Thus, the central bank seeks to combat deflation in the economy.

Objectives of Open Market Operations

The main objectives of open market operations are:

(a) To eliminate the effects of exports and imports to gold under the gold standard.
(b) To impose a check on the export of capital.
(c) To remove the shortage of money in the money market.
(d) To make bank rate more effective.
(e) To prevent a 'run on the bank'.

Conditions for the Success of Open Market Operations

The efficacy of open market operations as a tool of quantitative credit control requires the fulfillment of certain conditions discussed below.

1. **Institutional Framework:** The success of open market operations requires the existence of an institutional framework, that is, the existence of a well-knit and well developed securities market. The absence of a matured money market constitutes a serious impediment to the development of open market operations as an effective instrument of monetary control. In fact, in the under developed countries, the scope for open market operations is limited because of the absence of the institutional framework referred to above.
2. **Legal Framework:** The effective and meaningful functioning of open market operations calls for a suitable legal setting. The legal setting is that there should be no legal restrictions on the holding of securities by the central bank. It has been found that in some countries the governments have imposed ceilings on the holdings of government securities by central banks. Such legal restrictions obviously circumscribe the efficacy of open market operations.

3. **Maintenance of a Definite Cash Reserve Ratio:** Another condition that should be fulfilled for the success of open market operations is that the cash reserves of the banks should change in accordance with the purchase and sale of securities by the central bank. When the central bank purchases the securities, the cash reserves of the banks should increase and when the central bank sells the securities, the cash reserves of the banks should fall. This means that the banks should maintain a definite cash reserve ratio. But, if the banks keep the cash reserves in excess of the fixed ratio or have other secret reserves, the very purpose of open market operations will be defeated.
4. **Non-operation of Extraneous Factors:** Due to the operation of certain extraneous factors the cash reserves of the banks may not change in accordance with the requirement of open market operations. For example, when the central bank purchases the securities in order to inject more credit into the economy, this objective may be defeated by an outflow of money due to unfavourable balance of payments or the public may hoard a part of the additional cash put into circulation.
5. **Non-existence of Direct Access of Commercial Banks to the Central Bank:** Another important condition for the smooth working of the open market operations is that the commercial banks should not have direct access to the central bank for financial accommodation. In case the banks have direct accommodation to the central bank, then the reduction in their cash reserves through open market sale of securities by the central bank may be neutralised by these banks by borrowing from the central bank.

   It should be noted here that the above conditions necessary for the success of open market operations constitute by themselves the limitations of the open market operations. In fact, in many countries, particularly in the less developed countries, the success of open market operations is limited because the above conditions are not fulfilled.

Popularity of Open Market Operations

Despite the limitations of open market operations, it has been argued that this technique of credit control is superior to the bank rate policy. The superiority of open market operations stem from the following points:

(a) The discount rate policy seeks to regulate credit in an indirect way, whereas open market operations have a more direct and effective influence on the regulation of credit by the central bank.

(b) The influence of bank rate is on short term interest rates only. The long term interest rates are influenced only indirectly by changes in bank rate. But, the policy of open market operations has a direct bearing on the prices of long term securities and hence on the long term interest rates. It has a direct and immediate effect on the quantity of money and credit and hence on the market interest rates. It is on this score that the policy of open market operations is now increasingly used to influence the interest rates as well as the prices of government securities in the money market.

But, the above two points of the superiority of the policy of open market operations should not make us blind to the fact that the policy of open market operations will itself help to achieve the desired results. It is necessary to combine both bank rate and open market operations judiciously to achieve the desired results. Wherever possible, open market operations will have to be supplemented by the bank rate policy. This will go a long way in producing effective results in regulating the volume of credit in the economy.

A. *Variable Cash Reserve Ratio*

The traditional instruments of quantitative credit control, bank rate policy and open market operations, suffer from certain inherent defects and have been found unsuitable to serve the interests of underdeveloped countries. Hence, an entirely new and unorthodox instrument of quantitative credit control, in the form of variable reserve ratio, came into vogue, thanks to the Federal Reserve System of the United States. It was, however, Lord Keynes who was responsible for popularising the use of this novel technique of monetary management. The Federal Reserve System became the trendsetter by pressing into service variable reserve ratio for the first time in 1933 as a weapon of quantitative credit control.

Meaning

Variable Reserve Ratio refers to the percentage of the deposits of the commercial banks to be maintained with the central bank, being subject to variations by the central bank. In other words, altering the reserve requirements of the commercial banks is called variable reserve ratio.

It is a well known fact that all the commercial banks have to maintain a certain percentage of their deposits as cash reserves with the central bank. The central bank, therefore, acts as the custodian of the cash reserve of the commercial banks. By doing so, the central bank imparts liquidity and confidence into the system. This reserve requirement is subject to changes by the central bank depending upon the monetary needs and conditions of the economy.

In certain countries, like United States and India, there are clear written laws stipulating the banks to maintain the reserve requirements with the central bank. Such a reserve ratio is called the Statutory Reserve Ratio. But, in England, the banks maintain the reserve ratio as a matter of custom. Hence this kind of reserve ratio is called the Customary Reserve Ratio. Anyhow, the central bank has the authority to vary the reserve requirements of the banks.

B. *Theory of Variable Reserve Ratio*

The theory underlying the mechanism of variable reserve ratio is that by varying the reserve requirements of the banks, the central bank is in a position to influence the size of credit multiplier of the banks and therefore the supply of credit in the economy. An increase or decrease in the reserve requirements will have a contractionist or expansionary influence respectively on the supply of credit by the banking system.

Working of Variable Reserve Ratio

It is interesting to examine the working of variable reserve ratio as a technique of quantitative credit control. During a period of inflation, the central bank raises the reserve ratio in order to reduce the supply of credit in the economy and therefore to reduce the price level. When the reserve requirements of the banks are raised, the excess reserves of the banks shrink and hence the size of their credit multiplier decreases. It should be noted that the size of credit multiplier is inversely related to the reserve ratio prescribed by the central bank. An increase in the reserve ratio, therefore, discourages the commercial banks from expanding the supply of credit.

On the contrary during a period of deflation, the central bank lowers the reserve requirements of the banks in order to inject more purchasing power into the economy. When the reserve ratio is lowered, the excess reserves with the banks increase and hence the size of credit multiplier increases. This will have an encouraging effect on the ability of the banks to create credit. Thus, the central bank seeks to combat deflation in the economy.

Another variant of Variable Reserve Ratio is the method of Statutory Liquidity Ratio (S.L.R.) which is being used by the Reserve Bank of India. In this case, every scheduled bank in India is required under law to maintain certain liquid assets to meet its liabilities. These liquid assets comprise cash reserves with the central bank, balances with other banks in current account and investment in government securities. By varying the S.L.R., the central bank seeks to influence the credit creating capacity of the commercial banks. This method is known as the method of Secondary Reserve Requirements, and is being extensively used in western countries, like France, the U.S., Sweden, etc.

Other variants of Variable Reserve Ratio include the supplementary Reserve Requirements, Special Accounts System, Special Deposits System, etc.

There is a substantial measure of agreement that variable reserve ratio can be appropriately pressed into service when a country is experiencing large and sudden movements in its gold and foreign exchange assets, especially as a result of speculative international capital movements. The effects of large inflows and outflows of foreign capital can be counteracted smoothly and effectively by changes in the reserve requirements. Again, by varying the reserve ratio, it is possible to meet the minor fluctuations and shifts in the balance of payments position.

Though variable reserve ratio also has been a tool of quantitative credit control. It should be sharply distinguished from the traditional instruments of the bank rate and open market operations which belong to the same group. While the bank rate policy and open market operations alter the volume of free reserves of the banks indirectly by influencing the total amount of reserves, the variable reserve ratio does so directly. "Whereas the other two methods are designed to bring about an actual quantitative change in reserve holdings and thereby in free reserves a change in reserve requirements serves to create or destroy free reserves by a stroke of pen."

Limitations

The following constitute the limitations of variable reserve ratio:

(a) In the first place, variable reserve ratio has been considered to be a blunt and harsh instrument of credit control.

(b) As compared with the open market operations, it is inexact and uncertain as regards changes not only in the amount of reserves, but also the place where these changes can be made effective.

(c) Variable reserve ratio is accused of being discriminatory in its effect. It affects different banks differently. Banks with a large margin of excess reserves would be hardly affected whereas banks with small excess reserves would be hard pressed.

(d) Variable Reserve Ratio is considered to be inflexible. It lacks flexibility in that changes in reserve requirements would not be well adjusted to meet small or localized situations of reserve stringency or superfluity.

(e) This method of credit control is likely to create a panic among the banks and the investors.

(f) Maintaining the reserve ratio with the central bank imposes a burden on the banks because no interest is allowed on these cash reserves by the central bank.

(g) In the event of the commercial banks having huge foreign funds, the method of variable reserve ratio proves ineffective.

In view of the above limitations, according to De Kock, variable reserve ratio should be used "with moderation and discretion and only under abnormal conditions."

Yet, the case for variable reserve ratio is stronger than for bank rate policy and open market operations. Variable reserve ratio has the merit of being applied universally. It is considered to be the battery of the most improved type that the central bank has added to its armoury of the instruments of credit control. The technique of variable reserve ratio has been found extremely popular among the central banks of the less developed and the developing countries. As mentioned earlier, while the success of bank rate and open market operations calls for the fulfillment of certain conditions, in the case of variable reserve ratio, the desired results can be achieved just 'by a stroke of pen'.

From the above, we should not draw the conclusion that any of the three methods is preferable to the others. The right attitude should be not to accept this method or that method but to combine all the three methods in right proportions in order to secure effective results in the field of credit creation. The three methods, as we have seen above, have their own merits and demerits, and hence, no method, taken alone, can be successful in producing the desired results. Therefore, a judicious and skilful combination of all the three methods is essential in order to realize the objectives of credit control. These three methods may be combined in varying proportions to achieve effective results in the field of credit.

Selective or Qualitative Methods

The central bank may assume that the inflationary pressure in the country is due to artificial scarcities created by speculators and hoarders who may hoard and black market essential goods through the use of bank credit. Accordingly, the central bank may not regulate and

control the volume of credit but central the use of credit or the person's security, etc. Such controls are known as selective or direct controls. The special features of selective or qualitative controls are:

(a) They distinguish between essential and non-essential uses of bank credit.
(b) Only non-essential uses are brought under the scope of central bank controls.
(c) They affect not only the lenders but also the borrowers.

Selective controls attempt to cut down the credit extended for non-essential purposes or uses. Loans extended to speculators to hoard goods or bank credit to consumers to raise their demand for such durable goods as refrigerators, cars, etc., will prove to be inflationary when there is already excessive demand as compared to the limited supply. Essentially, therefore, selective controls are meant to control inflationary pressure in a country.

Objectives

The following are the broad objectives of selective instruments of credit control:

(a) To divert the flow of credit from undesirable and speculative uses to more desirable and economically more productive and urgent uses.
(b) To regulate a particular sector of the economy without affecting the economy as a whole.
(c) To regulate the supply of consumer credit.
(d) To stabilise the prices of those goods very much sensitive to inflation.
(e) To stabilise the value of securities.
(f) To correct an unfavourable balance of payments of the country.
(g) To bring under the control of the central bank credit created by non-banking financial intermediaries.
(h) To exercise control upon the lending operations of the commercial banks.

Measures of Selective Credit Control

For the purpose of selective credit control, the central bank generally uses the following forms of control, from time to time.

1. **Margin Requirements:** Banks are required by law to keep a safety margin against securities on which they lend. The central bank may direct banks to raise or reduce the margin. In the U.S.A. before World War II, the Federal Reserve Board fixed a margin of 40 per cent (i.e., a bank could lend up to 60 per cent of the value of security). But during the war and later, the margin requirements were raised from 40 per cent to 50 per cent, then to 75 per cent and in 1946 to 100 per cent in some cases. When the margin was raised to 75 per cent one could borrow only 25 per cent of the value of the security and when the margin requirement was fixed at 100 per cent one could borrow nothing. Thus by raising the margin requirement, the central bank could reduce the volume of bank credit which a commercial bank can grant

and a party can borrow. Margin requirement is a good tool to reduce the degree and extent of speculation in commodity market and stock exchanges.

2. **Regulation of Consumer Credit:** During the Second World War an acute scarcity of goods was felt in the U.S.A., and the position was worsened by the system of bank credit to consumers to enable them to buy durable and semi-durable consumer goods through instalment buying. The Federal Reserve Banks of the U.S.A., were authorised to regulate the terms and conditions under which consumer credit was extended by commercial banks. The restraints under these regulations were two-fold: (a) They limited the amount of credit that might be granted for the purchase of any article listed in the regulations; and (b) they limited the time that might be agreed upon for repaying the obligation. Suppose a buyer was required to make a down-payment of one-third of the purchase price of a car and the balance to be paid in 15 monthly instalments. Under the regulations restraining consumer credit, the down-payment was made larger and the time allowed was made shorter. The result was a reduction in the amount of credit extended for the purchase of cars and the time it was allowed to run; and the ultimate result was the restriction, in the demand for consumer goods at a time when there was a shortage in supply and when there was a necessity for restriction on consumer spending. This measure was a success in America in controlling inflationary pressures there. In the past-war period, it has been extensively adopted in all those countries where the system of consumer credit is common.

3. **Rationing of Credit:** Rationing of credit, as a tool of selective credit control, originated in England in the closing years of the 18th century. Rationing of credit implies two things. First, it means that the central bank fixes a limit upon its rediscounting facilities for any particular bank. Second, it means that the central bank fixes the quota of every affiliated bank for financial accommodation from the central bank.

   Rationing of credit occupies an important place in Russian Economic Planning. The central bank of the Russian Federation allocates the available funds among different banks in accordance with a definite credit plan formulated by the Planning Commission.

   But the criticism of rationing of credit is that it comes into conflict with the function of the central bank as a lender of the last resort. When the central bank acts as a lender of the last resort it cannot deny accommodation to any bank through it has borrowed in excess of its quota. Moreover, this method proves effective only when the demand for credit exceeds the supply of it.

4. **Control through Directives:** In the post-war period, most central banks have been vested with the direct power of controlling bank advances either by statute or by mutual consent between the central bank and commercial banks. For instance, the Banking Regulation Act of India in 1949 specifically empowered the Reserve Bank of India to give directions to commercial banks in respect of their lending policies, the purposes for which advances may or may not be made and the margins to be maintained in respect of secured loans. In England, the commercial banks have

been asked to submit to the Capital Issue Committee all loan applications in excess of £ 50,000. There is no uniformity in the use of directives to control bank advances. On the one extreme, the central bank may express concern over credit developments; the concern may be combined with mild threat to avoid increase or decrease in the existing level of bank loans. On the extreme, there can be a clear and open threat to the commercial banks financing certain types of activities.

5. **Moral Suation:** This is a form of control through directive. In a period of depression, the central bank may persuade commercial banks to expand their loans and advances, to accept inferior types of securities which they may not normally accept, fix lower margins and in general provide favourable conditions to stimulate bank credit and investment. In a period of inflationary pressure, the central bank may persuade commercial banks not to apply for further accommodation or not to use the accommodation already obtained for financing speculative or non-essential activities lest inflationary pressure should be further worsened. The Bank of England has used this method with a fair measure of success. But this has been mainly because of a high degree of co-operation which it always gets from the commercial banks.
6. **Direct Action:** Direct action or control is one of the extensively used methods of selective control, by almost all banks at sometime or the other. In a broad sense, it includes the other methods of selective credit controls. But more specifically, direct action refers to controls and directions which the central bank may enforce on all banks or any bank in particular concerning lending and investment. The Reserve Bank of India issued a directive in 1958 to the entire banking system to refrain from excessive lending against commodities in general and forbidding commercial banks granting loans in excess of Rs. 50,000 to individual parties against paddy and wheat. There is no doubt about the effectiveness of such direct action but then the element of force associated with direct action is resented by the commercial banks.
7. **Publicity:** Under this method, the central bank gives wide publicity regarding the probable credit control policy it may resort to by publishing facts and figures about the various economic and monetary condition of the economy. The central bank brings out this publicity in its bulletins, periodicals, reports etc.

Limitations of Selective Credit Controls

(a) The selective controls embrace the commercial banks only and hence the non-banking financial institutions are not covered by these controls.
(b) It is very difficult to control the ultimate use of credit by the borrowers.
(c) It is rather difficult to draw a line of distinction between the productive and unproductive uses of credit.
(d) It is quite possible that the banks themselves through manipulations advance loans for unproductive purposes.
(e) Selective controls do not have much scope under a system of unit banking.
(f) Development of alternative methods of business financing has reduced the importance of selective controls.

From the above discussion, we arrive at the conclusion that the two types of credit control measures, quantitative as well as qualitative, are not rivals, but, on the contrary, they supplement each other. For successful monetary management, the central bank should combine the two methods of credit control in appropriate proportions. In fact, a judicious and a skilful combination of general and selective credit control measures is the right policy to follow for the central bank of a country. It must, however, be pointed out that the various methods, whether quantitative or qualitative, cannot ensure perfect credit control in an economy in view of the several limitations from which they suffer, and other complexities involved in the situation.

Conclusion

To conclude, the central bank of a country acts as the leader of the money market, supervising, controlling and regulating the activities of commercial banks and other financial institutions. It acts as a bank of issue and is in close touch with the government, as banker, agent and adviser to the latter.

Questions for Discussion

1. What is a Central Bank? Explain the main functions of the Central Bank.
2. State and explain the various quantitative and qualitative methods of credit control generally adopted by central banks.
3. What do you mean by quantitative controls? Explain the different methods of quantitative credit controls.
4. What do you understand by selective or qualitative control? Explain fully the various methods of qualitative credit control.
5. Distinguish between bank rate policy and open market operation as methods of credit control.

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RESERVE BANK OF INDIA

INTRODUCTION

Several attempts were made from time to time to set up a Central Bank in India prior to 1934. But unfortunately these attempts failed to bear any fruit. In 1921, the Government of India established the Imperial Bank of India to serve as the Central Bank of the country. But the Imperial Bank did not achieve any appreciable success in its functioning as the Central Bank of the country. In 1925, the Hilton Young Commission was asked by the Government to express its views on the subject. The commission made out a forceful case for the establishment of a brand new Central Bank in the country. According to the Commission, it was not desirable to keep the control of currency and credit in the hands of two separate agencies. The Government of India controlled currency while the Imperial Bank regulated credit prior to the establishment of the Reserve Bank of India in April 1st, 1935. The Hilton Young Commission did not consider this double control on currency and credit as a desirable feature of the Indian monetary system. It was on this account that the Commission recommended the transfer of the control of currency and credit to a new Central Bank to be set up in the country. It was on this account that the Commission recommended the establishment of the Reserve Bank of India as the Central Bank of the country. The Government of India while accepting the recommendations of the Commission brought forward a Bill before the Central Legislature. But the Bill could not be passed on account of differences amongst the members of the legislature. The Government of India, therefore, postponed the idea of a new Central Bank for sometime. In 1929, the Central Banking Enquiry Committee again made a forceful plea for the establishment of the Reserve Bank. Consequently, the Reserve Bank of India Act was passed in 1934, and the Reserve Bank started functioning from 1st April, 1935.

The Reserve Bank of India is the kingpin of the Indian money market. It issues notes, buys and sells government securities, regulates the volume, direction and cost of credit, manages foreign exchange and acts as banker to the government and banking institutions.

The Reserve Bank is playing an active role in the development activities by helping the establishment and working of specialised institutions, providing term finance to agriculture, industry, housing and foreign trade. In spite of many criticisms, it has successfully controlled commercial banks in India and has helped in evolving a strong banking system. A study of the Reserve Bank of India will be useful, not only for the examination, but also for understanding the working of the supreme monetary and banking authority in the country.

Capital

Originally, the Reserve Bank was constituted as a shareholders bank, based on the model of leading foreign central banks of those days. The bank's fully paid-up share capital was Rs. 5 crores divided into shares of Rs. 100 each. Of this, Rs. 4,97,80,000 were subscribed by the private shareholders and Rs. 2,20,000 were subscribed by the Central Government for disposal of 2,200 shares at part to the Directors of the Bank (including members of the Local Boards) seeking the minimum share qualification. The share capital of the bank has remained unchanged until today. The Reserve Bank also had a Reserve Fund of Rs. 150 crores in 1982. It was nationalised in January 1949 and since then it is functioning as the State-owned bank and acting as the premier institution in India's banking structure.

Organisation

As per the Reserve Bank of India Act, the organisational structure of the Reserve Bank comprises:

(A) Central Board
(B) Local Boards

(A) Central Board

The Central Board of Directors is the leading governing body of the bank. It is entrusted with the responsibility of general superintendence and direction of the affairs and business of the Reserve Bank.

The Central Board of Directors consists of 20 members as follows:

1. **One Governor and four Deputy Governors:** They are appointed by the Government of India for a period of five years. Their salaries, allowances and other perquisites are determined by the Central Board of Directors in consultation with the Government of India.
2. **Four Directors Nominated from the Local Boards:** There are four local Boards of Directors in addition to the Central Board of Directors. They are located at Mumbai, Kolkata, Chennai and New Delhi. The Government of India nominates one member each from these local Boards. The tenure of these directors is also for a period of five years.
3. **Ten other Directors:** The ten other directors of the Central Board of Directors are also nominated by the Government of India. Their tenure is four years.

4. **One Government Official:** The Government of India also appoints one Government Official to attend the meetings of the Central Board of Directors. This official can continue for any number of years with the consent of the Government, but he does not enjoy the right to vote in the meetings of the Central Board.

   The Central Board of Directors exercises all the powers of the bank. The Central Board should meet at least six times in each year and at least once in three months. Usually, the Central Board keeps a meeting in March every year at New Delhi so as to discuss the budget with the Finance Minister after its presentation in parliament. Similarly, it keeps a meeting in August at Mumbai in order to pass the Bank's annual report and accounts.

   For all practical purposes, however, the committee set-up by the Central Board looks after the bank's current affairs. The committee consists of the Governor, the Deputy Governors and such other Directors as may be present. The committee meets once a week. Two sub-committees have also been appointed to assist the committee of the Central Board. Of these, one is called the Building Sub-Committee which deals with matters relating to building projects. The other is called the Staff Sub-Committee which is concerned with staff and other matters.

   The Governor is the highest official of the Reserve Bank. There are four Deputy Governors to help and advise him. Each Deputy Governor is allotted a particular job to do, and he is fully held responsible for the proper execution of the job.

(B) Local Boards

The Reserve Bank of India is divided into four regions : the Western, the Eastern, the Northern and the Southern regions. For each of these regions, there is a Local Board, with headquarters in Mumbai, Kolkata, New Delhi and Chennai.

Each Local Board consists of five members appointed by the Central Government for four years. They represent territorial and economic interests and the interests of co-operative and indigenous banks in their respective areas. In each Local Board, a chairman is elected from amongst their members. Managers in-charge of the Reserve Bank's offices in Mumbai, Kolkata, Chennai and New Delhi are ex-officio Secretaries of the respective Local Boards at these places.

The Local Boards carry out the functions of advising the Central Board of Directors on such matters of local importance as may be generally or specifically referred to them or performing such duties which may be assigned to them. Generally, a Local Board deals with the management of regional commercial transactions.

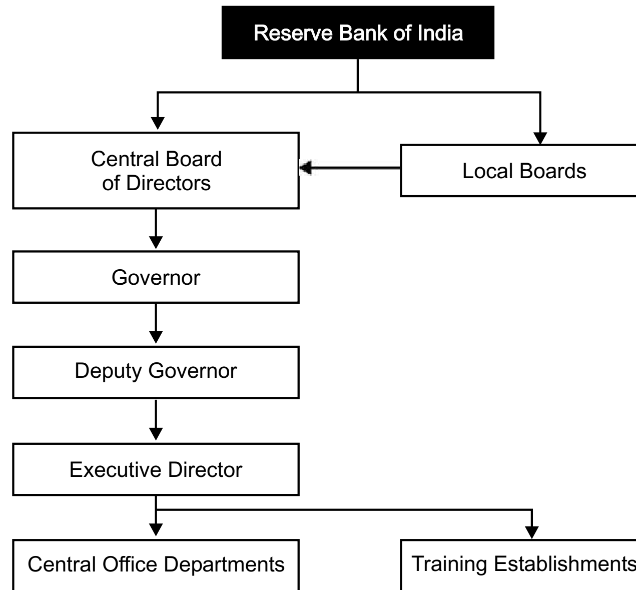
Offices of the Bank

The headquarters of the Reserve Bank is located at Mumbai. But for the efficient performance of its functions, the Bank has opened local offices at New Delhi, Kolkata, Chennai, Bangalore, Kanpur, Ahmedabad, Hyderabad, Patna and Nagpur. The Bank can open its office at any other place with the prior consent of the Central Government. The State Bank of India acts as the agent of the Reserve Bank at those places where the latter does not maintain its own

offices. The regional offices of the exchange control department of the Reserve Bank are located at New Delhi, Kanpur, Kolkata and Chennai.

The Reserve Bank has three training establishments viz., (a) Bankers Training College, Mumbai, (b) College of Agricultural Banking, Pune and (c) Reserve Bank Staff College, Chennai.

The organisational set-up of the Reserve Bank of India is depicted in following chart.



Departments of the Reserve Bank

To carry out its functions/operations smoothly and efficiently, the Reserve Bank of India has the following departments:

1. Issue Department.
2. Banking Department.
3. Department of Banking Development.
4. Department of Banking Operations.
5. Agricultural Credit Department.
6. Exchange Control Department.
7. Industrial Finance Department.
8. Non-Banking Companies Department.
9. Legal Department.
10. Department of Research and Statistics.
11. Department of Government and Bank Accounts.
12. Department of Currency Management.

13. Department of Expenditure of Budgetary Control.
14. Rural Planning and Credit Department.
15. Credit Planning Cell.
16. Department of Economic Analysis and Policy.
17. Inspection Department.
18. Department of Administration and Personnel.
19. Premises Department.
20. Management Services Department.
21. Reserve Bank of India Service Board.
22. Central Records and Documentation Centre.
23. Secretary's Department.
24. Training Establishments.

There are also Zonal Training Centres situated in Mumbai, Kolkata, Chennai and New Delhi for conducting induction, functional and short-term preparatory courses for the clerical staff.

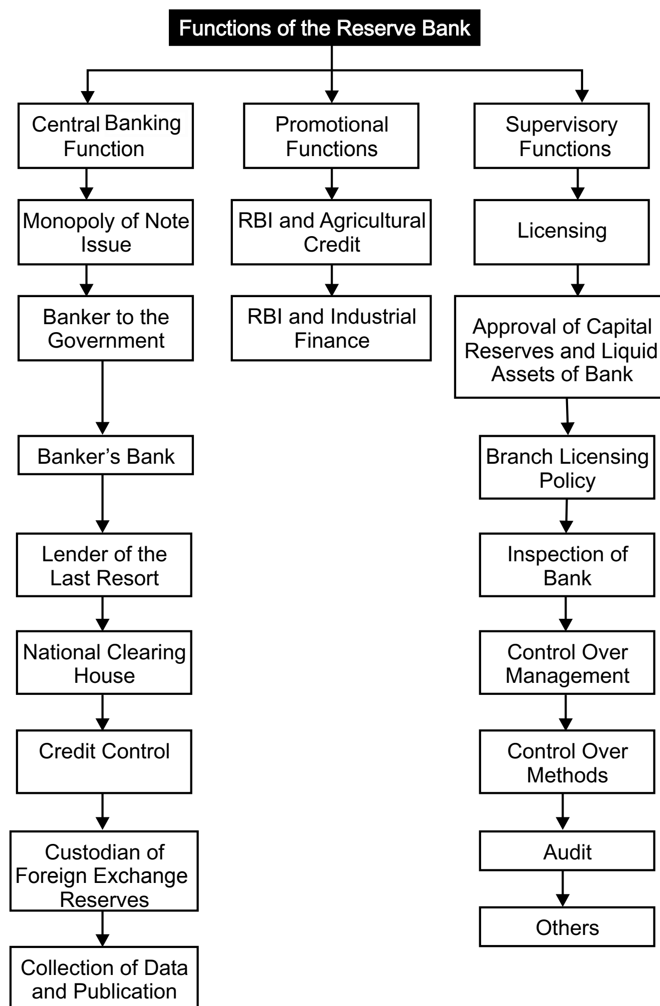
Functions of the Reserve Bank

According to the preamble of the Reserve Bank of India Act, the main functions of the bank is "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." The various functions performed by the RBI can be conveniently classified in three parts as follows:

A. Traditional Central Banking Functions

The Reserve Bank of India discharges all those functions which are performed by a central bank. Among these the more important functions are as follows:

1. **Monopoly of Note Issue:** Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denomination. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department, originally, the assets of the Issue Department were to consist of not less than two fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the second World War and the post-war period, these provisions were considerably modified since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the Minimum Reserve System.



2. **Banker to the Government:** The Reserve Bank of India serves as a banker to the Central Government and the State Governments. It is its obligatory function as a central bank. It provides a full range of banking services to these Governments, such as:
   (a) Maintaining and operating of deposit accounts of the Central and State Government.
   (b) Receipts and collection of payments to the Central and State Government.
   (c) Making payments on behalf of the Central and State Government.
   (d) Transfer of funds and remittance facilities of the Central and State Governments.
   (e) Managing the public debt and issue of new loans and Treasury Bills of the Central Government.

(f) Providing ways and means advances to the Central and State governments to bridge the interval between expenditure and flow of receipts of revenue. Such advances are to be repaid by the government within three months from the date of borrowal.

(g) Advising the Central/State governments on financial matters, such as the quantum, timing and terms of issue of new loans. For ensuring the success of government loan operations, the RBI plays an active role in the gilt-edged market.

(h) The bank also tenders advice to the government on policies concerning banking and financial issues, planning as resource mobilisation. The Government of India consults the Reserve Bank on certain aspects of formulation of the country's Five Year Plans, such as financing pattern, mobilisation of resources, institutional arrangements regarding banking and credit matters. The government also seeks the bank's advice on policies regarding international finance, foreign trade and foreign exchange of the country.

The Reserve Bank has constituted a sound research and statistical organisation to carry out its advisory functions effectively.

(i) The Reserve Bank represents the Government of India as member of the International Monetary Fund and World Bank.

3. **Banker's Bank:** The Reserve Bank has the right of controlling the activities of the banks in the country. All the commercial banks, co-operative banks and foreign banks in the country have to open accounts with the bank and are required to keep a certain portion of their deposits as reserves with the Reserve Bank. Cash reserves are not to be less than 3% of the demand and time liabilities of the bank. The Reserve Bank has the power to increase this ratio upto 15%. Through this, Reserve Bank is able to regulate and control the credit created by the commercial banks. In addition to this, the scheduled banks are also required to submit to the Reserve Bank a number of returns every Friday.
4. **Lender of the Last Resort:** The scheduled banks can borrow from the Reserve Bank on the basis of eligible securities. They can also get the bills of exchange rediscounted. The Reserve Bank acts as the clearing house of all the banks. It adjusts the debits and credits of various banks by merely passing the book entries. The Bank also provides free remittance facilities to the banks. Thus, it acts as the banker's bank. The Reserve Bank also acts as the lender of the last resort and an emergency bank. It grants short-term loans to scheduled commercial banks against eligible securities in time of need. Similarly, it rediscounts the eligible bills of exchange brought by the commercial banks.
5. **National Clearing House:** The Reserve Bank acts as the national clearing house and helps the member banks to settle their mutual indebtedness without physically transferring cash from place to place. The Reserve Bank is managing many clearing houses in the country with the help of which cheques worth crores of rupees are

cleared every year. The ultimate balances are settled by the banks throught cheques on the Reserve Bank.

6. **Credit Control:** The Reserve Bank of India is the controller of credit, i.e., it has the power to influence the volume of credit created by bank in India. It can do so through changing the bank rate or through open market operation. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

   The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India. The licence can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

(a) It holds the cash reserves of all the scheduled bank.

(b) It controls the credit operation of banks through quantitative and qualitative controls.

(c) It controls the banking system through the system of licensing, inspection and calling for information.

(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

7. **Custodian of Foreign Exchange Reserves:** The Reserve Bank has the responsibility of maintaining the external value of the rupee. There is centralisation of the entire foreign exchange reserves of the country with the Reserve Bank to avoid fluctuations in the exchange rate.

   The RBI has the authority to enter into foreign exchange transactions both on its own account and on behalf of government. The bank is also empowered to buy and sell foreign exchange from and to scheduled banks in amounts of not less than the equivalent of Rs. 1 lakh.

   As the custodian of the nation's foreign exchange reserves, the RBI also administers exchange controls of the country, and enforces the provision of the Foreign Exchange Regulation Act, 1973.

8. **Collection of Data and Publications:** The Reserve Bank of India collects statistical data and economic information through its research departments. It compiles data on

the working of commercial and co-operative banks, on balance of payments, company and government finances, security markets, price tends, and credit measures.

The bank is the principal source of certain financial statistics and banking data. It publishes a monthly bulletin, with weekly statistical supplements and annual reports which present a good deal of periodical reviews and comments pertaining to general economic, financial, and banking developments, including the bank's monetary policies and measures, adopted for the qualitative and quantitative monetary management.

The followings are the regular publications of the Bank:

(a) Reserve Bank of India Bulletin (monthly) and its weekly statistical supplements.
(b) Report of the Central Board of Directors (Annual).
(c) Report on Trend and progress of Banking in India (Annual).
(d) Report on Currency and Finance (Annual).
(e) Review of the Co-operative Movement in India (Published once in two years).
(f) Banking Statistics (Basic Statistical Returns).
(g) Statistical Tables Relating to Banks in India.
(h) Statistical Statements Relating to the Co-operative Movement in India.
(i) Adboc Export Committee's Reports and Monographs.
(j) Results of surveys conducted by the bank, such as the survey of India, Foreign Liabilities and Assets, All-India Debt and Investment Survey 1971-72, etc.
(k) History of the Reserve Bank of India (1935-51).
(l) Functions and Working of the Reserve Bank of India.
(m) Banking and Monetary Statistics of India and its Supplements.
(n) Reserve Bank of India Occasional Paper (Bi-annual).

B. Promotional Functions

The scope of the functions performed by the Reserve Bank has further widened after the introduction of economic planning in the country. The bank now performs a variety of promotional and developmental functions. The bank's responsibilities include, apart from monetary functions, the institutionalisation of savings through the promotion of banking habit and the expansion of banking system territorially and functionally. The RBI has to provide facilities for agricultural and industrial finance.

(a) **Reserve Bank of India and Agricultural Credit:** The bank's responsibility in this field has been occasioned by the predominantly agricultural basis of the Indian economy and the urgent need to expand and coordinate the credit facilities available to the rural sector. The RBI has set up a separate agricultural department to maintain an expert staff to study all questions of agricultural credit and coordinate the operation of the bank with other agencies providing agricultural finance. The RBI does not provide finance directly to the agriculturists, but through agencies like cooperative

banks, land development banks, commercial bank etc. After the establishment of the National Bank for Agriculture and Rural Development (NABARD) on July 12, 1982, all the functions of the RBI relating to rural credit have been transferred to this new agency.

(b) **Reserve Bank of India and Industrial Finance**: The Reserve Bank of India has taken initiative in setting up statutory corporations at the all-India and regional levels to function as specialised institutions for term lending. The first of these institutions was the Industrial Finance Corporation of India set up in 1948. Followed by the State Finance Corporations in each of the state from 1953 onwards. The RBI has also helped in the establishment of other financial institutions such as the Industrial Development Bank of India, the Industrial Reconstruction Bank of India, Small Industries Development Bank of India, Unit Trust of India, etc. For the promotion of foreign trade the Reserve Bank has established the Export and Import Bank of India. Similarly, for the development of the housing industry the RBI has established the National Housing Bank.

Furthermore, the Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly owned subsidiary of the Reserve Bank, operates credit guarantee schemes with the objective of providing cover against defaults in repayment of loans made to small borrowers, including small-scale industrial borrowers, in order that credit flow to them is enlarged.

C. Supervisory Functions

Over the years, extensive powers have been conferred on the Reserve Bank of India for supervision and control of banking institutions. The Banking Regulation Act 1949, provides wide powers to the Reserve Bank to regulate and control the activities of Banks to safeguard the interests of depositors. Amendment Act passed in 1963, and effective from February 1, 1964, provided further powers to the Reserve Bank, particularly to restrain control exercised by particular groups of persons over the affairs of bank and to restrict loans and advances as well as guarantees given by the bank to or on behalf of any one company, firm, association of persons, and gave greater control to the Reserve Bank over the appointment and removal of bank's executive personnel.

The various aspects of the supervisory/regulatory functions exercised by the Reserve Bank may be briefly mentioned as under:

1. **Licensing of Banks:** There is a statutory provision that a company starting banking business in India has first to obtain a licence from the Reserve Bank. If the Reserve Bank is dissatisfied on account of the defective features of the proposed company, it can refuse to grant the licence. The bank is also empowered to cancel the license of a bank when it will cease to carry on banking business in India.
2. **Approval of Capital, Reserves and Liquid Assets of Bank:** The Reserve Bank examines whether the minimum requirements of capital, reserve and liquid assets are fulfilled by the banks and approves them.

3. **Branch Licensing Policy:** The Reserve Bank exercises its control over expansion of branches by the banks through its branch licensing policy.

   In September 1978, the RBI formulated a comprehensive branch licensing policy with a view to accelerate the pace of expansion of bank offices in the rural areas. This was meant to correct regional imbalance of the banking coverage in the country.

4. **Inspection of Banks:** The Reserve Bank is empowered to conduct inspection of banks. The inspection may relate to various aspects such as the bank's organisational structure, branch expansion, mobilisation of deposits, investments, credit portfolio management, credit appraisal profit planning, manpower planning, as well as assessment of the performance of banks in developmental areas such as deployment of credit to the priority sectors, etc. The bank may conduct investigation whenever there are complain about major irregularities or frauds by certain banks. The inspections are basically meant to improve the working of the banks and safeguard the interests of depositors and thereby develop a sound banking system in the country.

5. **Control Over Management:** The Reserve Bank also looks into the management side of the banks. The appointments, re-appointment or termination of appointment of the chairman and chief executive officer of a private sector bank is to be approved by the Reserve Bank. The bank's approval is also required for the remuneration, perquisites and post retirement benefits given by a bank to its chairman and chief executive officer.

   The Boards of the public sector banks are to be constituted by the Central Government in consultation with the Reserve Bank.

6. **Control Over Methods:** The Reserve Bank exercises strict control over the methods of operation of the banks to ensure that no improver investment and injudicious advances made by them.

7. **Audit:** Banks are required to get their balance sheets and profits and loss accounts duly audited by the auditors approved by the Reserve Bank. In the case of the SBI, the auditors are appointed by the Reserve Bank.

8. **Credit Information Service:** The Reserve Bank is empowered to collect information about credit facilities granted by individual bank and supply the relevant information in a consolidated manner to the bank and other financial institutions seeking such information.

9. **Control Over Amalgamation and Liquidation:** The banks have to obtain the sanction of the Reserve Bank for any voluntary amalgamation. The Reserve Bank in consultation with the central government can also suggest compulsory reconstruction or amalgamation of a bank. It also supervises banks in liquidation. The liquidation have to submit to the Reserve Bank returns showing their positions. The Reserve Bank keeps a watch on the progress of liquidation proceedings and the expenses of liquidation.

10. **Deposit Insurance:** To protect the interest of depositors, banks are required to insure their deposits with the Deposit Insurance Corporation. The Reserve Bank of

India has promoted such a corporation in 1962, which has been renamed in 1978 as the Deposit Insurance and Credit Guarantee Corporation.

11. **Training and Banking Education:** The RBI has played an active role in making institutional arrangement for providing training and banking education to the bank personnel, with a view to improve their efficiency.

    In brief, the Reserve Bank of India is performing both traditional central banking functions and developmental functions for the steady growth of the Indian economy.

CREDIT CONTROL

Commercial banks grant loans and advances to merchants and manufacturers. They create credit or bank deposits in the process of granting loans. In modern times, bank deposits are regarded as money. They are as good as cash. They can be used for the purchase of goods or in payment of debts. But excessive creation of credit by commercial bank leads to inflation. Inflation has serious social and economic consequence. For instance, people with fixed incomes, workers and salaried persons suffer greatly on account of rising prices. So, a Central Bank must control the credit created by commercial banks in order to maintain the value of money at a stable level. Similarly, excessive contraction of credit leads to deflation. Deflation leads to unemployment and suffering among workers. Under such circumstances the central bank should encourage credit creation. Hence it is essential that the creation of credit is kept within reasonable limits by the central bank. The central bank has to control and regulate the availability of credit, the cost of cost and the use of credit flow in the economy. Credit control is an important function of the central bank. The central bank is in a position to control credit in its capacity as the bank of issue and the custodian of the cash reserves of the commercial bank.

Weapons of Credit Control

Various weapons or methods or instruments are available to the Reserve Bank of India to control credit creation or contraction by commercial banks. These methods are divided into two categories:

(A) Quantitative or general methods or instruments.
(B) Qualitative or selective methods or instruments.

A. Quantitative or General Methods

These are traditional methods of credit control. These methods have only a quantitative effect on the supply of credit. They are used for either increasing or reducing the volume of credit. They cannot control credit for its quality. The important quantitative methods or instruments of credit control are as follows:

1. **Bank Rate:** The bank rate is the rate of interest at which the Reserve Bank of India makes advances to the commercial banks against approved securities or rediscounts the

eligible bills of exchange and other commercial papers. The Reserve Bank of India Act, 1934 defines the bank rate as "the standard rate at which it (the Bank) is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act." The change in the bank rate leads to changes in the market rates of interest i.e., short-term as well as long-term interest rates. If bank rate is raised rates of interest in the money market including the lending rates of commercial banks also rise. So the cost of credit rises. The demand for bank loans generally falls and so the demand for goods will also fall. Thus inflation can be checked or controlled by raising bank rate. Similarly, deflation (i.e., state of falling prices) can be checked by lowering the bank rate. So the bank rate acts as a "pace-setter" in the money market.

The Reserve Bank of India has changed the bank rate from time to time to meet the changing conditions of the economy. The bank rate was raised for the first time, from 3 per cent to 3½ per cent, in November 1951, with a view to checking an undue expansion of bank credit. The bank rate was further raised to 4 per cent on May 16, 1959. In February 1965, the bank rate was further raised to 6 per cent. In March 1968, however, the bank rate was reduced to 5 per cent with a view to stimulating recovery from the industrial recession of 1967. In January 1971, the bank rate was, however raised to 6 percent as an anti-inflationary device. Subsequently, the bank rates was raised to 10 per cent in July 1981 and to 12 per cent in October 1991. The bank rate was, however, reduced to 10 per cent in June 1997. The increases in the bank rate were adopted to reduce bank credit and control inflationary pressures. The Reserve Bank of India has made only a modest use of this instrument.

2. **Open Market Operations:** Open market operations consist of buying and selling of government securities by the Reserve Bank. Open market operations have a direct effect on the availability and cost of credit. When the central bank purchases securities from the banks, it increases their cash reserve position and hence, their credit creation capacity. On the other hand, when the central bank sells securities to the banks, it reduces their cash reserves and the credit creation capacity. The Reserve Bank of India did not rely much on open market operations to control credit. It was not used for influencing the availability of credit. Due to under-developed security market, the open market operations of the Reserve Bank are restricted to Government securities. These operations have also been used as a tool of public debt management. They assist the Indian government to raise borrowings. During 1951-52 the sale of securities was more. But in 1961 the purchases were more. This proves that it is not used to credit restraint only.

In India, the open market operations of the Reserve Bank has not been so effective because of the following reasons:

(a) Open market operations are restricted to government securities.
(b) Gift-edged market is narrow.
(c) Most of the open market operations are in the nature of "switch operations" (i.e., purchasing one loan against the other).

3. **Cash-Reserve Requirement (CRR):** The central bank of a country can change the cash-reserve requirement of the commercial banks in order to affect their credit creation capacity. An increase in the cash-reserve ratio reduces the excess reserves of the banks and a decrease in the cash-reserve ratio increases their excess reserves. The variability in cash-reserve ratios directly affects the availability and cost of credit. Originally, the Reserve Bank of India Act, 1934 required the commercial banks to keep with the Reserve Bank a minimum cash reserve of 5 % of their demand liabilities and 2 % of time liabilities. The amendment of the Act in 1962 removes the distinction between demand and time deposits and authorises the Reserve Bank to change cash reserve ratio between 3 and 15 %. The method of variable cash-reserve ratio is the most direct, immediate and the most effective method to credit control.

   The Reserve Bank of India used the technique of variable cash reserve ratio for the first time in June, 1973. It raised the cash reserve ratio from 3 to 5 % in June 1973. The cash-reserve ratio was further raised to 7 % in September 1973. Since then, the Reserve Bank has raised or reduced the cash reserve ratio many times. Recently, the cash reserve ratio was raised to 11 % effective from July 30, 1988 and to 15 % with effect from July 1989. The present cash-reserve ratio is 13 %. This method is mainly intended to control and stabilise the prices of commodities, stocks and shares and prevent speculation and hoarding. The Reserve Bank used the CRR as a drastic measure to curb credit expansion.

4. **Statutory Liquidity Ratio (SLR):** Under the Banking Regulation Act, 1949, banks are required to maintain liquid assets in the form of cash, gold and unencumbered approved securities equal to not less than 25 % of their total demand and time deposits. This minimum statutory liquidity ratio is in addition to the statutory cash-reserve ratio. Maintenance of adequate liquid assets is a basic principle of sound banking. The Reserve Bank has been empowered to change the minimum liquidity ratio. Accordingly, the liquidity ratio was raised from 25 % to 30 % in November 1972, to 32 % in 1973, to 35 % in October 1981, to 38 % in January 1988, and to 38.5 % in September 1990. There are two reasons for raising the statutory liquidity requirements or ratio by the Reserve Bank of India. They are:

   (a) It reduces commercial bank's capacity to create credit and thus helps to check inflationary pressures.

   (b) It makes larger resources available to the government.

   In view of the Narasimham committee report, the government decided to reduce the statutory liquidity ratio in stages over a 3 year period from 38.5 % to 25 %. As a first step in this direction, it was reduced to 38 % in April 1992. The statutory liquidity ratio was reduced to 37.75 % in March 1993 and to 33.75 % in September 1994. The statutory liquidity ratio was further reduced to 32.75 % in April 1997.

B. Qualitative Selective Methods

Selective credit controls are qualitative credit control measures undertaken by the central bank to divert the flow of credit from speculative and unproductive activities to productive

and more urgent activities. Selective credit controls are better than the quantitative credit controls in many respects. They encourage credit to essential industries and at the same time discourage credit to non-essential industries. Similarly, they encourage productive activities and at the same time discourage speculative activities. In a developing economy like India, qualitative credit controls are mainly intended for the following purposes:

(a) To prevent anti-social use of credit like speculative hoarding of stock.
(b) To divert credit from unproductive activities to productive activities.
(c) To divert credit from non-essential to essential industries.
(d) To encourage credit for certain sectors like priority sector.

METHODS OF SELECTIVE CREDIT CONTROLS ADOPTED BY RESERVE BANK

The Banking Regulation Act, 1949, granted wide powers to the Reserve Bank of India to adopt selective methods of credit control. The Act empowered the Reserve Bank to issue directions to the banks regarding their advances. These directives may relate to the following:

(a) The purpose for which advances may or may not be made.
(b) The margins to be maintained on secured loans.
(c) The maximum amount of advances to any firm or company, and
(d) The rate of interest to be charged.

The Reserve Bank of India has undertaken the following selective credit controls to check speculative and inflationary pressures and extend credit to productive activities.

1. **Variation of Margin Requirements:** The "margin" is the difference between the "loan value" and the "market value" of securities offered by borrowers against secured loans. By fixing the margin requirements on secured loans, the central bank does not permit the commercial banks to lend to their customers the full value of the securities offered by them, but only a part of their market value. For example, if the central bank prescribes the margin requirements at 40 %, that means that the commercial banks can lend only 60 % of the market value of the securities of the customers. If the margin is raised to 50 %; the banks can lend only 50 % of the market value of the securities to the customers. Thus, by changing the margin requirements, the amount of loan made by the banks can be changed in accordance with the policy of the central government. If the central bank raises the margin requirements, the amount of bank advances against securities will be automatically reduced. As a result the bank credit will be diverted from the field of speculative activities to the other fields of productive investments. If, on the contrary, the central bank lowers down the margin requirements, the amount of bank advances to the customers against securities can be automatically increased. Thus by altering margin requirements from time to time, the central bank keeps on changing the volume of bank loans to the borrowers. This method is an effective way of checking the flow of credit to less productive and less desirable uses in the economy.

The Reserve Bank of India has been increasingly using this method in recent years to control bank advances against essential commodities like food-grains, oil-seeds, sugar etc. The main object is to prevent speculative dealings in such commodities. In 1957, the margin against loans on food-grains was increased to 40% and again to 60% in 1970. In March, 1977, the minimum margin was fixed at 85% on advances against stocks of groundnut oil, castor oil etc. This was done to check undue rise in the price of oil-seeds and vanaspathi. The margin requirements were also increased in the case of pulses, sugar, vanaspathi and oil-seeds in subsequent years. During 1984-85 the maximum margins on bank advances against stocks of food-grains was 45% in the case of mills and 60% in the case of others. Reserve Bank has been using this method flexibly according to the needs of the situation. The margin requirements was increased when the prices are going up and decreased when the credit flow has to be increased.

2. **Credit Authorisation Scheme (CAS):** Credit Authorisation Scheme is a type of selective credit control introduced by the Reserve Bank in November, 1965. Under the scheme, the commercial banks had to obtain Reserve Bank's authorisation before sanctioning any fresh credit of Rs. 1 crore or more to any single party. The limit was later gradually raised to Rs. 6 crores in 1986, in respect of borrowers in private as well as public sector. Under this scheme, the Reserve Bank requires the commercial banks to collect, examine and supply detailed information regarding the borrowing concerns. The main purpose of this scheme is to keep a close watch on the flow of credit to the borrowers. This scheme requires that the banks should lend to the large borrowing concerns on the basis of credit appraisal and actual requirements of the borrowers. But this scheme was abolished in 1982. Though the scheme has been abolished, the Reserve Bank, however, insists that the banks have to get its approval once the loans have been sanctioned by them to big borrowers. The Reserve Bank would monitor and scrutinise all sanctions of bank loans exceeding Rs. 5 crores to any single party for working capital requirements, and Rs. 2 crores in the case of term loans. This post-sanction scheme has been called "Credit Monitoring Arrangement (CMA)."
3. **Control of Bank Advances:** This is also used as selective control method. The Reserve Bank has fixed from time to time maximum limits for some kinds of loans and advances. In May 1956, the Reserve Bank issued a directive asking all the commercial banks in the country to restrict their advances against paddy and rice. This directive was issued to check speculative hoarding of paddy and rice. In September 1956, these restrictions were applied to cover food-grains, pulses and cotton textiles. In 1970, the maximum limit for loans against shares and debentures was fixed to Rs. 5 lakhs. This was done to prevent speculation in shares with the help of bank loans.
4. **Differential Interest Rates:** In 1966, the Reserve Bank announced the policy of "Selective Liberalisation of Credit." According to this policy, the Reserve Bank encouraged credit to defence industries, export industries and food-grains for procurement by government agencies. The Reserve Bank agreed to provide refinance

at the bank rate in respect of advances to the above industries. At the same time it made credit dearer for other purposes.

5. **Credit Squeeze Policy:** Since 1973, the Reserve Bank has adopted a "Credit squeeze policy" or dear money policy as an anti-inflationary measure. This policy aims at curbing overall loanable resources of banks and also enhancing the cost or credit of borrowers from banks.
6. **Moral Suasion:** This method involves advice, request and persuasion with the commercial banks to co-operate with the central bank in implementing its credit policies. The Reserve Bank has also been using moral suasion as a selective credit control measure from 1956. It has been sending periodic letters to the commercial banks to use restraint over their credit policies in general and in respect of certain commodities and unsecured loans in particular. In June 1957, the banks were advised to reduce advances against agricultural commodities. Regular meetings and discussions are also held by the Reserve Bank with commercial banks to impress upon them the need for their co-operation in the effective implementation of the monetary policy.

   Selective credit controls are flexible. They can be tightened, relaxed, withdrawn and re-imposed according to price situation in the market. For influencing the purpose and direction of credit. The Reserve Bank has been using various selective credit controls. It should be noted that qualitative methods are not competitive but complementary to quantitative methods of credit control. Both methods should be employed to control credit created by commercial banks.

Limitations of Selective Controls in India

The Reserve Bank implemented various measures of qualitative control to channelise the flow of credit into productive sectors and restricted the financing of speculative and unproductive activities. The successful operation of selective credit controls, however, suffers from the following limitations:

(a) Traders mostly use their own finance for holding stocks of commodities. This self-financing or private financing reduces the rate of bank finance and its influence.

(b) Traders may manage to get credit from non-controlled sectors and use it in controlled sectors. It is very difficult to ensure that the borrowers use the amount for the purpose for which it is borrowed.

(c) The Reserve Bank has no control over the activities of non-banking financial institutions as well as indigenous bankers. These institutions and bankers play a significant role in financing trade and industry in Indian economy.

(d) The Reserve Bank is not fully equipped with tools and powers to control effectively the inflationary trends in the country. Its general and selective controls are effective only to the extent to which inflationary pressures are the result of bank finance. But the Reserve Bank's credit control measures may not prove effective in case, the inflationary pressures are caused by deficit financing and shortage of goods.

(e) Existence of large quantity of money in the black market also poses a serious limitation to the credit policy of the Reserve Bank. Speculation and hoarding are also carried on with the help of black money. The Reserve Bank could not exercise its effective control over the expansion of black money in the Indian economy.

The methods of selective control are more suitable for under developed countries like India. It is essential to divert credit to more essential industries for speedier economic development. The methods of selective credit control can prove helpful in the achievement of this objective. If the Reserve Bank has not undertaken different selective control methods to check inflationary pressures, the price position in the country might have been some what worse. The selective credit controls, if they are applied along with quantitative credit control methods, have a great role to play in our planned economy.

MONETARY POLICY OF THE RESERVE BANK OF INDIA

Monetary policy, generally refers to those policy measures of the central bank which are adopted to control and regulate the volume of currency and credit in a country. According to Paul Einzig, an ideal monetary policy may be defined "as an effort to reduce to a minimum the disadvantages and increase the advantages resulting from the existence and operation of a monetary system." Broadly speaking, by monetary policy is meant the policy pursued by the central bank of a country for administering and controlling country's money supply including currency and demand deposits and managing the foreign exchange rates:

Reserve Bank of India and Monetary Controls

The main objective of monetary policy pursued by the Reserve Bank of India is that of 'controlled monetary expansion.' In order to achieve this objective the Reserve Bank has at its disposal various instruments, the important among these are as follows:

1. Quantitative requirements, and
2. Qualitative or selective controls.

In a developing country like India, the most important objective of monetary policy should be that of 'controlled monetary expansion.' Controlled monetary expansion implies two things:

(a) Expansion in the supply of money, and
(b) Restraint on the secondary expansion of credit.

(a) Expansion in the Supply of Money

In a developing country like India, money supply has to be expanded sufficiently to match the growth of real national income. Although it is difficult to say what relation the rate of increase in money supply should bear to the rate of growth in national income, more generally, the rate of increase in money supply should be somewhat higher than the projected rate of growth of real national income for two reasons.

(i) As incomes grow the demand for money as one of the components of savings tends to increase.

(ii) Increase in money supply is also necessitated by gradual reduction of non-monetised sector of the economy.

In India, the rate of increase in money supply has been far in excess of the rate of growth in real national income. It has resulted, to a large extent, in the creation of consistent inflationary pressures in the economy.

(b) Restraint on the Secondary Expansion of Credit: Government budgetary deficits for financing a part of the investment outlays constitute an important source of monetary expansion in India. It is, therefore essential to restrain the secondary expansion of credit. While exercising restraints, care should be taken that the legitimate requirements of agriculture, industry and trade are not adversely affected. The Reserve Bank has also to channelise credit into the vital sectors of the economy, specially the priority sectors.

In order to achieve the twin goals, it is essential to formulate a monetary policy which may regulate the flow of credit to desired sectors. So far as the choice of instruments of the monetary policy is concerned, the Reserve Bank of India has a very limited scope in this respect. The Reserve Bank has at its disposal both quantitative (traditional) and qualitative (selective) methods to control credit. In the past, the Reserve Bank has employed bank rate, open market operations, variable reserves ratio and selective credit controls as the instruments to restrain the secondary expansion of credit.

The progress of the various methods of credit control, contemplated by the Reserve Bank of India suggests that the objective of monetary policy i.e., 'controlled monetary expansion' has been realised to a limited extent. While the supply of money has increased in a greater proportion than the national income, the restraints on the expansion of credit have been rather weak and ineffective. In spite of the various methods employed by the Reserve Bank to contain the inflationary pressures, the general price level has been showing a rising trend. It leads up to this inevitable conclusion that there is something wrong with the monetary policy pursued by the Reserve Bank of India in the recent post. The policy should be that of 'controlled contraction' rather than 'controlled expansion.'

However, if we take into account the nature of the Indian economy and the needs of developmental finance, it would be a folly on our part to adopt a monetary policy of 'controlled contraction'. India is a developing economy, and for the overall development of the various sectors like agriculture, industry, trade, commerce, transport, and foreign trade, availability of huge financial resources is essential. With the concept of developmental planning gaining momentum, the availability of monetary resources in sufficient quantity becomes all the more essential. With limited supply of money the Indian economy will not be able to achieve the objective of self-sustained economic growth. Therefore, the RBI will have to continue with the policy of controlled expansion. The only change that the RBI has to introduce is that it will have to implement the various restraints on the expansion of credit more vigorously and with great authority.

Limitations of Monetary Policy

A major failure of the monetary policy in India lies on the price front. The monetary authorities have not been in a position to curb an inflationary rise in price which has often taken violent jumps at intervals. A number of causes account for this failure.

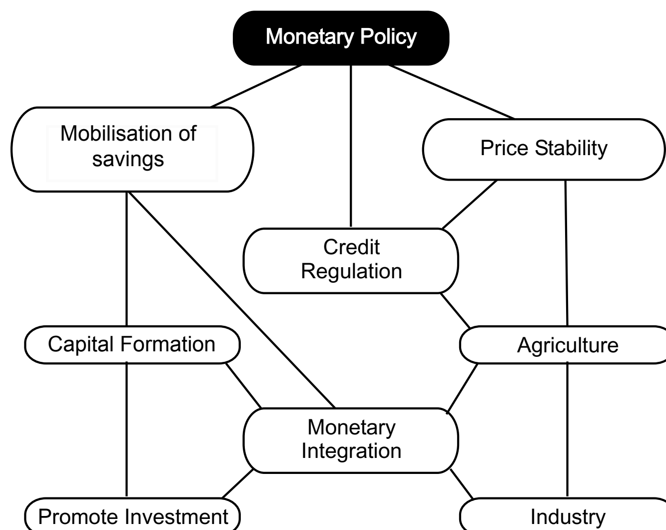
(a) Monetary policy, to be effective, should be able to regulate supply and cost of credit. The Reserve Bank tries to do by controlling the activities of commercial banks and to some extent of co-operative banks. But the proportion of total credit provided by non-banking institutions and other agencies is much higher. The impulses generated by the Reserve Bank have thus a limited impact.

(b) In relation to commercial banks the task of the Reserve Bank is rendered difficult by the limitations inherent in the various instruments of monetary control.

(c) In part the freedom to curtain Reserve Bank accommodation for banks is also constrained by the fact that the device of offering preferential facilities has been used for encouraging banks to lend to such sectors with so many windows opened for refinance as an adjunct to efforts to change the long-term pattern of bank finance, it becomes difficult for the Reserve Bank to close these special windows just when the banks may find it necessary or tempting to use these special facilities.

(d) There is a special consideration that hitherto neglected sectors should be shielded as far as possible from credit curbs. This makes the task of the monetary policy more difficult.

(e) The type of the policy the Reserve Bank has pursued so far requires the presence of a sound statistical and monitoring system. Any defects in this system make it difficult to bring about a speedy and appropriate turn around in credit trends.



Coverage of Monetary Policy

Chakravarthy Report on the Working of the Monetary System

The committee to review the working of the monetary system headed by S. Chakravarthy submitted its report to the RBI in April 1985. In its terms of reference this committee was required to provide a review of the monetary system and recommend measures for making monetary policy more effective. The committee dealt particularly with the objectives of monetary policy; coordination between monetary policy and fiscal policy; regulation of money supply; maintenance of price stability; interest rate policy and utilisation of credit. Its main recommendations are as follows:

(a) The committee had stressed the need to pursue price stability as the primary objective of the monetary policy. However, it suggested that this objective should not come in conflict with the other socio-economic goals embodied in the five year plans. The committee pointed out that the major factor that contributed to **colossal** increase in the money supply had been the RBI's credit to the government. The committee thus recommended that an appropriate framework for the regulation of the RBI's credit to the government should be evolved.

(b) The official concept of budgetary deficit did not allow in the past to clearly know the monetary impact of fiscal operations. The committee, therefore, suggested a change in the definition of budgetary deficit. The budgetary deficit of the Central Government was measured in terms of an increase in treasury bills. In the opinion of the committee, this overstated the extent of the monetary impact of fiscal operations because no distinction was made between the absorption of treasury bills and the increase in the holdings of treasury bills by the RBI.

(c) The committee was of the view that banks should have greater freedom in determining their lending rates. This would prevent unnecessary use of credit which presently is possible due to relatively low rates. Further the committee strongly felt that concessional interest rates as a redistributive device should be used in a very selective manner.

(d) The committee did not favour continuance of cash credit as the predominant form of bank credit. In its opinion, certain measures should be undertaken to encourage loans and bills finance forms of bank credit. It also stressed the importance of credit system in the area of priority sector lending. This would enable adequate and timely flow of credit to the priority sectors.

(e) The committee was of the view that the money market in India should be restructured. In its opinion, in the restructured monetary system the treasury bills market, the call money market, the commercial bills market and the inter-corporate funds market should play an important role in the allocation of short term resources. The committee also recommended that the RBI should adopt all the measures which are necessary to develop an efficient money market in this country.

The major recommendations of the Chakravarthy Committee were accepted and have been implemented. The committee had stressed the need for developing aggregate monetary targets to ensure orderly monetary growth. The government has thus on an experimental basis

carried out an exercise to evolve such targets in consultation with the RBI. The government has also accepted in principle that increase in entire RBI credit to the government should be reflected in the budget in addition to the narrowly defined figure of the budget deficit. Keeping in view the recommendations of the committee the yields on long-term government securities have been increased and the maturities have been reduced. Moreover, now treasury bills of 364 days maturity are being issued by the RBI. These short-term instruments with flexible rates would enable banks to manage their liquidity better and help in evolving an active secondary market in short term instruments.

The Narasimham Committee Report (1991)

The Government of India set up a nine-member committee under the chairmanship of M. Narasimham, a former Governor of the Reserve Bank of India, to examine all aspects relating to the structure, organisation, functions and procedures of the financial system. This committee on the financial system submitted its report in November 1991. In order to improve the functioning of the financial sector, particularly the banking sector in India, Narasimham Committee has suggested wide-ranging measures.

Recommendations of the Committee

Narasimham Committee made a number of recommendations to improve the productivity, efficiency and profitability of the banking sector. The main recommendations of the committee are:

1. **Structural Reorganisation of the Banking Structure:** To bring about greater efficiency in banking operations, the Narasimham Committee proposed a substantial reduction in the number of public sector banks through mergers and acquisitions. According to the committee, the broad pattern should consist of:
   (a) 3 or 4 large banks (including the State Bank of India) which could became international in character.
   (b) 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking.
   (c) Local banks whose operations would be generally confined to a specific region; and
   (d) Rural banks including Regional Rural Banks mainly engaged in financing agriculture and allied activities in rural areas.
2. **Licensing of Branches:** The committee proposed that the present system of licensing of branches should be discontinued. Banks should have the freedom to open branches purely on profitability considerations.
3. **Freedom to Foreign Banks to open Offices:** The committee recommended that the Government should allow foreign banks to open offices in India either as branches or as subsidiaries. Foreign banks and Indian banks should be permitted to set up joint ventures in regard to merchant and investment banking, leasing and other forms of financial services.

4. **Removal of the Duality of Control of Banks:** The committee recommended that the present system of dual control over the banking system between Reserve Bank and the Banking Division of the Ministry of Finance should end immediately. Reserve Bank of India should be the primary agency for the regulations of the banking system.
5. **Setting up of Assets Reconstruction Fund:** Narasimaham Committee recommended the setting up of the "Assets Reconstruction Fund" to take over from the nationalised banks and financial institutions, a portion of their bad and doubtful debts at a discount. All bad and doubtful debts of the banks were to be transferred in a phased manner to ensure smooth and effective functioning of the Assets Reconstruction Fund.
6. **Special Tribunals for Recovery of Loans:** Banks at present face many difficulties in recovering the loans advanced by them. Therefore, the committee recommended that special tribunals should be set up for recovering loans granted by banks.
7. **Directed Credit Programmes:** The committee recommended that the system of directed credit programme should be gradually phased out. The concept of priority sector should be redefined to include only the weakest section of the rural community. The directed credit programme for the priority sector should be fixed at 10 per cent of the aggregate bank credit. The committee argued that the system of directed credit should be temporary and not a permanent one.
8. **Statutory Liquidity Ratio (SLR):** The committee recommended that the statutory liquidity ratio should be gradually reduced from the present 38.5 per cent to 25 per cent over the next five years.
9. **Cash Reserve Ratio (CRR):** The committee recommended that CRR should be progressively reduced from the present high level of 15 per cent to 3 to 5 per cent.
10. **De-regulation of Interest Rates:** The committee recommended that all controls and regulations on interest rates on lending and deposit rates of banks and financial institutions should be removed.
11. **Capital Adequacy:** The committee proposed that banks should achieve 8 per cent capital adequacy ratio as recommended by Basle Committee by March 1996.
12. **Banks in the Private Sector:** The committee recommended that the Reserve Bank of India should permit the setting up of new banks in the private sector, provided they satisfy all the conditions and norms prescribed by the Reserve Bank. Further, there should be no difference in treatment between public sector banks and private sector banks.
13. **Raising Capital Through the Capital Market:** Profitable banks and banks with good reputation should be permitted to raise capital from the public throught the capital market. Regarding other banks, the government should subscribe to their capital or give a loan. Which should be treated as a subordinate debt, to meet their capital requirements.

14. **Proper Classification of Assets:** The committee recommended that the assets of bank should be classified into 4 categories: (a) standard (b) sub-standard (c) doubtful, and (d) loss assets. Full disclosures of assets and liabilities should be made in the balance-sheets of banks and financial institutions as per the International Accounting Standards reflecting the real state of affairs.
15. **Free and Autonomous Banks:** The committee recommended that the public sector banks should be free and autonomous.
16. **Liberalisation of Capital Market:** The committee recommended liberalisation of the capital market. The office of the "Controller of Capital Issues" should be abolished. There should be no need to get prior permission from any agency to issue capital. The capital market should be opened for foreign portfolio investments.

    The recommendations of the Narasimham Committee (1991) were revolutionary in many respects. Most of the recommendations have been accepted by the government and implemented during the 8th Five year plan.

The Goiporia Committee Report (1991)

Banking in India has made a remarkable progress in its growth and expansion, as well as business. But the quality of customer service has deteriorated day-by-day. To meet the new challenges in the changing environment of liberalised financial system. Indian banks have to be modernised, become more efficient and competitive. The banking sector has to face stiff competition from mutual funds started by various financial institutions and schemes launched by the Unit Trust of India. The saving instruments of non-banking financial institutions, and various small saving schemes of government are more attractive from the investing public point of view. As a result the annual growth rate in deposits has remained almost stagnant in recent years. Improving customer service' is one of the major steps the banks are required to take for greater deposit mobilisation. The Reserve Bank of India appointed committees from time to time to make necessary recommendations for improvement in customer service. In September, 1990, the Reserve Bank of India set up a committee under the chairmanship of Sri M.N. Goiporia to examine the problem of customer service in banks and suggest measures to improve the situation.

Recommendations of Goiporia Committee

The committee submitted its report on 6th December, 1991. Main recommendations of the committee are as follows:

(a) Extension of banking hours for all transactions, except cash.
(b) Change in the commencement of working hour for bank staff to facilitate timely opening of bank counters.
(c) Immediate credit of outstation cheques upto Rs. 5000/- as against Rs. 2,500/- at present.
(d) Enhancement of interest rate on saving account.

(e) Introduction of tax benefits against bank deposits.
(f) Full use of discretionary powers vested in the bank staff at all levels.
(g) Expeditious despatch of documents lodged for collection.
(h) Extension of teller's duties.
(i) Modernisation of banks.
(j) Opening of specialisation branches for different customer groups.
(k) Introduction of a new instrument in the form of bank order.
(l) Introduction of restricted holidays in banks.

Most of the recommendations were accepted by the Reserve Bank of India, and are being implemented.

The Narasimham Committee Report (1998)

The Finance Ministry of the Government of India set up "Banking Sector Reforms Committee" under the chairmanship of Mr. M. Narsimham in 1998. This committee submitted its report in April, 1998 to the Government of India. Important findings and recommendations of the Narasimham committee (1998) are as follows:

1. **Need for a Stronger Banking System:** The Narasimham Committee has made out a strong case for a stronger banking system in the country. For this purpose, the committee has recommended the merger of strong banks which will have a "multiplier effect" on industry. The committee has also supported that two or three large strong banks be given international or global character.
2. **Experiment with the Concept of Narrow Banking:** The committee has suggested the adoption of the concept of "narrow banking" to rehabilitate weak banks.
3. **Small, Local Banks:** The committee has suggested the setting up of small, local banks, which would be confined to states or cluster of districts in order to serve local trade, small industry and agriculture.
4. **Capital Adequacy Ratio:** The committee has suggested higher capital adequacy requirements for banks. It has also suggested the setting up of an "Asset Reconstruction Fund" to take over the bad debts of the banks.
5. **Review and Update Banking Laws:** The Narasimham Committee (1998) has suggested the urgent need to review and amend the provisions of Reserve Bank of India Act, Banking Regulation Act, State Bank of India Act and Bank Nationalisation Act so as to bring them in line with the current needs of the banking industry.

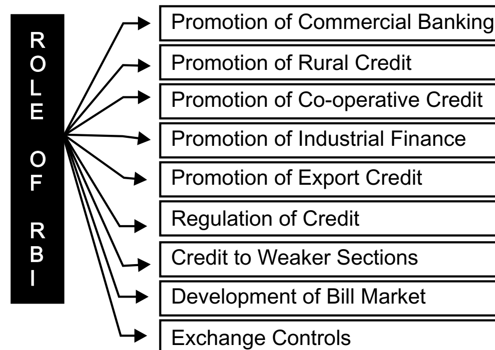
ROLE OF RBI IN ECONOMIC DEVELOPMENT

The Reserve Bank is India's central bank. It occupies a pivotal position in the monetary and banking structure of our country. It is the apex monetary institution in the country. It supervises, regulates, controls and develops the monetary and financial system of the country. It performs all the typical functions of a good central bank. It also performs a

number of developmental and promotional functions. It also assists the government in its economic planning. The bank's credit planning is devised and co-ordinated with the Five year plans. It assists the government in the great task of nation building.

Contribution to Economic Development

Since its inception in 1935, the Reserve Bank of India has functioned with great success, not only as the apex financial institution in the country but also as the promoter of economic development. With the introduction of planning in India since 1951, the Reserve Bank formulated a new monetary policy to aid and speed up economic development. The Reserve Bank has undertaken several new functions to promote economic development in the country. The major contributions of the Reserve Bank to economic development are as follows:



1. **Promotion of Commercial Banking:** A well-developed banking system is a pre-condition for economic development. The Reserve Bank has taken several steps to strengthen the banking system. The Banking Regulation Act, 1949 has given the Reserve Bank vast powers of supervision and control of commercial banks in the country. The Reserve Bank has been using these powers:
   (a) To strengthen the commercial banking structure through liquidation and amalgamation of banks, and through improvement in their operational standards
   (b) To extend the banking facilities in the semi-urban and rural areas, and
   (c) To promote the allocation of credit in favour of priority sectors, such as agriculture, small-scale industries, exports etc.

   The Reserve Bank is also making valuable contribution to the development of banking system by extending training facilities, to the supervisory staff of the banks through its 'Banker's training colleges.
2. **Promotion of Rural Credit:** Defective rural credit system and deficient rural credit facilities are one of the major causes of backwardness of Indian agriculture. In view of this, the Reserve Bank, ever since its establishment, has been assigned the responsibility of reforming rural credit system and making provision of adequate institutional finance for agriculture and other rural activities. The Reserve Bank has taken the following steps to promote rural credit:

(a) It has set up Agricultural Credit Department to expand and co-ordinate credit facilities to the rural areas.

(b) It has been taking all necessary measures to strengthen the co-operative credit system with a view to meet the financial needs of the rural people.

(c) In 1956, the Reserve Bank set-up two funds. Namely, the National Agriculture Credit (long-term operations) Fund, and the National Agricultural Credit (stabilisation) Fund, for providing medium-term and long-term loans to the state co-operative banks.

(d) Regional rural banks have been established to promote agricultural credit.

(e) Some commercial bank have been nationalised mainly to expand bank credit facilities in rural areas.

(f) The National Bank for Agriculture and Rural Development has been established in 1982 as the apex institution for agricultural finance.

(g) The Reserve Bank has helped the establishment of many warehouses in the country.

As a result of the efforts made by the Reserve Bank, the institutional finance for agriculture has been increasing considerably over the years. The agricultural output has increased by leaps and bounds. Probably no other central bank in the world is doing so much to help, develop and finance agricultural credit.

3. **Promotion of Co-operative Credit:** Promotion of co-operative credit movement is also the special function of the Reserve Bank. On the recommendations of the Rural Credit Survey Committee, the Reserve Bank has taken a number of measures to strengthen the structure of co-operative credit institutions throughout the country. The Reserve Bank provides financial assistance to the agriculturists through the co-operative institutions. The Reserve Bank has, thus, infused a new life into the co-operative credit movement of the country.

4. **Promotion of Industrial Finance:** Credit or finance is the pillar to industrial development. The Reserve Bank has been playing an active role in the field of industrial finance also. In 1957, it has set up a separate Industrial Finance Department which has rendered useful service in extending financial and organisational assistance to the institutions providening long-term finance. It made commendable efforts for broadening the domestic capital market for providing the medium and long-term finance to the industrial sector. In this regard the Reserve Bank took initiative in the establishment of a number of statutory corporations for the purpose of providing finance, especially medium and long-term finance, to industries; Industrial Development Bank of India, Industrial Finance Corporation of India, State Finance Corporations, State Industrial Development Corporations and the Industrial Credit and Investment Corporation of India are some of important corporations established in the country with the initiative of the Reserve Bank. The Reserve Bank has contributed to the share capital of these institutions and providing short-term advances also to some of them. The role of these corporations in providing financial

help to industries is commendable. The Reserve Bank has played an active role in the establishment of the Unit Trust of India. The Unit Trust of India mobilises the savings of people belonging to middle and lower income groups and uses these funds for investment in industries. By mobilising the small savings of the people, the Unit Trust has been promoting capital formation which is the most important determinant of economic development. The Reserve Bank also has been encouraging commercial banks to provide credit to the small-scale industries. It has been encouraging credit for small industries through its "Credit Guarantee Scheme." Small-scale industries have been recognised as a priority sector. The Reserve Bank has also been, acting as a "developmental agency" for planning, promoting and developing industries to fill in the gaps in the industrial structure of the country.

5. **Promotion of Export Credit:** "Export or Perish" has become a slogan for the developing economies, including India. In recent years, India is keen on expanding exports. Growth of exports needs liberal and adequate export credit. The Reserve Bank has undertaken a number of measures for increasing credit to the export sector. For promoting export financing by the banks, the Reserve Bank has introduced certain export credit schemes. The Export Bills Credit Scheme, and the Pre-shipment Credit Scheme are the two important schemes introduced by the Reserve Bank. The Reserve Bank has been stipulating concessional interest rates on various types of export credit granted by commercial banks. The Reserve Bank has been instrumental in the establishment of Export-Import Bank. The Exim Bank is to provide financial assistance to exporters and importers. The Reserve Bank has authority to grant loans and advances to the Exim Bank, under certain conditions.
6. **Regulation of Credit:** The Reserve Bank has been extensively using various credit control weapons to regulate the cost of credit, the amount of credit, and the purpose of credit. For regulating the cost and amount of credit the Reserve Bank has been using the quantitative weapons. For influencing the purpose and direction of credit, it has been using various selective credit controls. By regulating credit, the Reserve Bank has been able
   (a) To promote economic growth in the country.
   (b) To check inflationary trends in the country.
   (c) To prevent the financial resources from being used for speculative purposes.
   (d) To make financial resources available for productive purposes keeping in view the priorities of the plans, and
   (e) To encourage savings in the country.
7. **Credit to Weaker Sections:** The Reserve Bank has taken certain measures to encourage adequate and cheaper credit to the weaker sections of the society. The "Differential Rate of Interest Scheme" was started in 1972. Under this scheme, concessional credit is provided to economically and socially backward persons engaged in productive activities. The Reserve Bank has been encouraging the commercial banks to give liberal credit to the weaker sections and for self employment schemes.

The Insurance and Credit Guarantee Corporation of India gives guarantee for loans given to weaker sections.

8. **Development of Bill Market:** The Reserve Bank introduced the "Bill Market Scheme" in 1952, with a view to extend loans to the commercial banks against their demand promissory notes. The scheme, however, was not based on the genuine trade bills. In 1970, the Reserve Bank introduced "New Bill Market Scheme" which covered the genuine trade bills representing sale or despatch of goods. The bill market scheme has helped a lot in developing the bill market in the country. The bill market scheme has increased the liquidity of the money market in India.
9. **Exchange Controls:** The Reserve Bank has been able to maintain the stability of the exchange value of the "Rupee" even under heavy strains and pressure. It has also managed "exchange controls" successfully.

 Inspite of the limitations under which it has to function in a developing country like India, the over all performance of the Reserve Bank is quite satisfactory. It has been able to develop the financial structure of the country consistent with the national socio-economic objectives and priorities. It has discharged its promotional and developmental functions satisfactorily and acted as the leader in economic development of the country.

Conclusion

From the above discussion, it is made clear that the Reserve Bank of India is the kingpin of the Indian money market. It issues notes, buys and sells government securities, regulates the volume, direction and cost of credit, manages foreign exchange and acts as banker to the government and banking institutions. The RBI is playing an active role in the development activities by helping the establishment and working of specialised institutions, providing term finance to agriculture, industry housing and foreign trade.

Questions for Discussion

1. Discuss the important functions of the Reserve Bank of India.
2. Explain the quantitative method employed by the Reserve Bank of India in order to make its credit policy effective.
3. "Selective credit control is a successful instrument of credit control policy of the Reserve Bank of India." Discuss with special reference to recent trends.
4. Describe briefly the working of the Narasimham Committee Reports.
5. Discuss the view that the right objective of monetary policy in India currently should be "controlled contraction" and not "controlled expansion" of bank credit.
6. Examine the role of the Reserve Bank of India in economic development of India.

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STATE BANK OF INDIA

INTRODUCTION

The Reserve Bank of India had been attempting to help the villagers through the state-cooperative banks but the extent of its assistance was very limited. At the same time, the need to help the farmers in all possible ways so as to increase agricultural production has been most pressing since independence. The All India Rural Credit Survey Committee (AIRCSC) recommended the setting up of a State Bank of India, a commercial banking institution, with the special purpose of stimulating banking development in rural areas. The State Bank of India was set up in July 1, 1955, when it took over the assets and liabilities of the former Imperial Bank of India.

Capital

The State Bank of India has authorised share capital of Rs. 20 crores and an issued share capital of Rs. 5,625 crores which has been allotted to the Reserve Bank of India. The shares of the SBI are held by the Reserve Bank of India, insurance companies and the general public who were formerly shareholders of the Imperial Bank of India. The State Bank of India and its associate banks are engaged in the economic development of the country through a wide network of 13,306 (30-6-2000) branches spread over the country. After 1955, there has been a steady increase in the assets and liabilities of the State Bank of India.

Management

The management of the State Bank vests in a Central Board constituted thus: A Chairman and a Vice-chairman appointed by the Central Government in consultation with the Reserve Bank; not more than two Managing Directors appointed by the Central Board with the approval of the Central Government; six Directors elected by the shareholders other than

the Reserve Bank; eight Directors nominated by the Central Government in consultation with the Reserve Bank to represent territorial and economic interests, not less than two of whom shall have special knowledge of the working of co-operative institutions and of the rural economy; one Director nominated by the Central Government; and one Director nominated by the Reserve Bank.

Functions

The State Bank of India performs all the functions of a commercial bank and acts as an agent of the Reserve Bank in those places were the latter has no branch offices. Further it is required to play a special role in rural credit, namely, promoting banking habits in the rural areas, mobilising rural savings and catering to their needs. It is expected to look after the banking development in the country. It provides financial assistance to the small scale industries and the co-operative institutions.

We can discuss the functions of the State Bank under the following three sub-heads:

A. Central Banking Functions

Though the State Bank is not the Central Bank of the country, yet it acts as the agent of the Reserve Bank in all those places where the latter does not have its own branches. As agent to the Reserve Bank, the State Bank performs some very important functions:

1. **It acts as the Bankers Bank:** It receives deposits from the commercial banks and also gives loans to them on demand. The State Bank rediscounts the bills of the commercial banks. It also acts as the clearing-house for the other commercial banks. In addition to this the State Bank also provides cheap remittance facilities to the commercial banks.
2. **It acts as the Government's Banker:** It collects money from the public on behalf of the government and also makes payments in accordance with its instructions. The bank also manages the public debt of the Central and the State Governments.

B. Ordinary Banking Functions

The ordinary banking functions of the State Bank are as follows:

1. **Receiving Deposits from the Public:** Like other commercial banks, the State Bank also receives different types of deposits from the public. The total deposits of the State Bank stood at Rs. 36,188 crores on 29th June, 1990. Of this amount, Rs. 7,105 crores were demand deposits and Rs. 29,083 crores were time deposits.
2. **Investment in Securities:** Like other commercial banks, the State Bank invests its surplus funds in the Securities of Government of India, the State Governments, Railway Securities, Securities of Corporations and Treasury Bills. The total amount invested by the State Bank in these securities stood at Rs. 9,942 crores on 29th June, 1990.
3. **Loans and Advances to Businessmen:** The State Bank grants loans and advances to businessmen against the security of government papers, exchange bills, approved

promissory notes and title deeds. The total advances of the State Bank to businessmen stood at Rs. 24,047 crores on 29th June, 1990.

4. **Foreign Banking:** In recent years, the State Bank of India has extended its foreign banking business. It has opened its branches in important world banking centres, such as Nassau, Singapore, Hong Kong, London, New York, Frankfurt etc. The Bank's foreign business is expanding every year. It has been able to give a new direction to its foreign business. The State Bank, in collaboration with leading foreign banks, has also been extending loans to foreign governments.
5. **Miscellaneous Work:** The miscellaneous functions of the State Bank are as follows:
   (a) The State Bank can receive securities, jewels etc. for safe custody.
   (b) Sale and purchase of gold, silver, bullion and coins.
   (c) Safe custody of the valuables of its customers.
   (d) Issuing of credit certificates to the customers.
   (e) Issuing drafts on its own as well as the branches of the subsidiary banks.
   (f) Telegraphic remittance of funds from one place to another place.
   (g) Acting as the agent of the co-operative banks under certain circumstances.
   (h) Working as the liquidator of banking companies and doing other miscellaneous jobs assigned to it by the Reserve Bank.
   (i) The State Bank grants special credit facilities to small scale industries and co-operative societies.

C. Prohibited Business of the State Bank

The State Bank of India Act has enumerated certain business which cannot be done by the State Bank.

(a) The State Bank cannot grant loans against stocks and shares for a period exceeding six months. But, according to an amendment of the Act, made in 1957, the State Bank can grant loans to industries against their assets for a period of 7 years.
(b) The State Bank can purchase no immovable property except for its own offices.
(c) The State Bank cannot re-discount those bills which do not carry at least two good signatures.
(d) The State Bank could neither discount bills nor extend credit to individuals or firms above the sanctioned limit.
(e) The State Bank can neither re-discount nor offer loans against the security of those exchange bills whose period of maturity exceeds six months.

Role of the State Bank in Economic Development

Growth of banking facilities is indispensable for speedy economic development. By helping in the encouragement of small savings, mobilisation of savings and development of credit into the priority sectors, the State Bank of India is playing a significant role in India's economic development. The role of the SBI can be studied under the following heads:

1. **The SBI and Small-scale Industries:** State Bank Group has been the most important single source of institutional finance to small-scale industries in the country. The SBI has set up several pilot centres, to experiment with financing schemes. Through its Instalment Credit Scheme the SBI provides finances for the purchase of equipments and machinery by small and medium size business engaged in approved manufacturing industries. In 1967, the State Bank introduced the "Entrepreneur Scheme", under which credit to the small sector was based on the ability and competence of the entrepreneurs as well as the technical feasibility and economic viability of the project.
2. **The SBI and Agricultural Credit:** The SBI provides direct advances to farmers for all agricultural operations and indirect loans to Primary Co-operative Credit Societies, Farmers Service Societies, etc. The SBI Group provides agricultural advances for a variety of purposes which include loans to co-operative banks, advances to Land Development Banks, Village Adoption Scheme, Integrated Rural Development, Financial Assistance to marketing and processing societies, development of warehousing facilities, etc.
3. **The SBI and Small Road and Water Transport:** The development of transport facilities, especially in the rural areas, is very vital for the maximum utilisation of the localised resources. The SBI provides advances to the small road and water transport operators at concessional rates.
4. **The SBI and Industrial Estates:** The State Bank of India has been playing a significant role in the establishment of industrial estates in the country. The total advances for setting up of industrial estates have increased to over Rs. 2 crores in June 1989.
5. **The SBI and Export Promotion:** The State Bank of India also helps in the export promotion by providing finances to exporters, maintaining close relationship between exporters and importers, collecting and disseminating information about market etc. About 30 per cent of the total export finance of scheduled banks comes from the SBI Group.
6. **The SBI and Regional Development:** The SBI is also helping in reducing the regional disparities by establishing a major portion of its new branches in the rural and unbanked areas. The Lead Bank Schemes has been very successful in the integrated development of the rural areas.

   In brief, the State Bank of India is playing the role of leading public sector commercial bank for the speedy economic development of the Indian economy.

Conclusion

Thus, the SBI is truly shaping itself as a national institution of major financial importance. It has helped in making more effective Government control over the country's money market.

It has extended appreciably banking facilities to rural and other areas lacking badly in such facilities. The Bank massive resources are made available to the high priority sectors of the economy according to the objectives of planned development. To achieve so much in such a short time is highly creditable indeed.

Questions for Discussion

1. Explain the functions of the State Bank of India.
2. Explain the role of the State Bank of India in economic development of the country.

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Money Market and Capital Market

INTRODUCTION

The money market concerns trading in money instruments involving borrowing and lending for short periods. It is part of the securities market. The other part is capital market which deals with long-term instruments like equity or shares, debentures and bonds. It provides long-term finance to the government and firms, mostly large ones.

Money Market

Money Market is a short-term credit market. It is the centre in which short-term funds are borrowed and lent. It consists of borrowers and lenders of short-term funds. The borrowers are generally merchants, traders, brokers, manufacturers, speculators and Government. The lenders are commercial banks, insurance companies, finance companies and the central bank. The money market brings together the lenders and the borrowers. It does not deal in cash or money. It deals in trade bills, promissory notes and government papers or bills, which are drawn for short-periods. Dr. S.N. Sen defines money market as "the organisation for the lending of short-term funds, through the use of such instruments as commercial bills of exchange, short-term government securities and banker's acceptances."

The Reserve Bank of India describes money market as "the centre for dealings, mainly of a short-term character, in monetary assets, and it meets the short-term requirements of borrowers and provides liquidity or cash to lenders."

Functions of Money Market

A well-organised and developed money market can help a country to achieve economic growth and stability. It performs a diversity of functions in the banking structure of the economy. They are:

(a) Money market provides outlets to commercial banks, non-banking financial concerns, business corporations and other investors for their short-term funds. It enables them to use their excess reserves in profitable investment.
(b) Money market also provides short-term funds to businessmen, industrialists, traders etc. to meet their day-to-day requirements of working capital. Money market plays a crucial role in financing both internal as well as international trade.
(c) Money market provides short-term funds not only to private businessmen but also to government and its agencies.
(d) Money market enables businessmen, with temporary surplus funds, to invest them for a short period.
(e) Money market serves as a medium through which the central bank of the country exercises control on the creation of credit.
(f) Money market is also of great help to the government.

The functions of the money market are virtually the same in all the countries of the world. But the institutions, instruments and modes of operation are different in different money markets.

Composition of the Money Market

The money market is composed of several financial agencies that deal with different types of short-term credit. We may describe the following important components of the money market:

1. **Call Money Market:** It is a market for short-period loans. Bill brokers and dealers in stock exchange require financial accommodation for very short periods. Money may be lent for periods not exceeding seven days. Sometimes money is lent only overnight. These loans are called call loans or call money as the banks recall these loans at very short notice. The banks prefer this kind of investment for two reasons. Firstly, call loans can be treated almost like cash and they form the second line of defence for the banks after cash. Secondly unlike cash, the call loans earn some income, in the form of interest, for the banks. The commercial banks are the lenders and the bill brokers and dealers in stock exchange are the borrowers in the call money market. The call money market is an important section of the money market.
2. **Collateral Loan Market:** When loans are offered against collateral securities like stocks and bonds, they are called 'collateral loans' and the market is known as the collateral loan market. This market is geographically most diversified.
3. **Acceptance Market:** It refers to the market for bankers acceptances which arise out of trade-both inland and foreign. When goods are sold to anyone on credit, the buyer accepts a bill. Such a bill cannot be discounted anywhere easily. The banker adds his credit to the bill by accepting it on behalf of his customer who has purchased the goods. Such bills can be discounted anywhere. In London, there are specialist firms called acceptance houses which accept bills drawn on them by traders. They are well known all over the world. In the past, the acceptance market was a prominent

section of London money market. Its importance has declined considerably in recent years. The function of the acceptance houses is being performed by the commercial banks is several countries.

4. **Bill Market or Discount Market:** It refers to the market where short-dated bills and other paper is discounted. Before the First World War the most important paper discounted in the London money market was the commercial bill which was used to finance both inland and foreign trade. During the inter-war period the importance of the commercial bills declined. This place has been taken by treasury bills. The treasury bills are promissory note of the government to pay a specified sum after a specified period, generally 90 days. The treasury bills are purchased by the investors and when necessary they are discounted in the discount market.

   These markets are not water-tight compartments. They are related to one another. The borrowers in the call money market deal in treasury bills which are discounted with them. Acceptance houses accept bills which are later discounted in the discount market. Thus, the various sections of the money market are intimately related to and are dependent on one another.

Financial Institutions of the Money Market

The money market may also be analysed on the basis of the different institutions engaged in lending and borrowing short-term funds. The nature of these institutions may differ from country to country. The same institutions may also function both as borrower and as lender in the market. The lenders are:

1. **The Central Bank:** It is the lender of last resort. It lends money to commercial banks when they approach for financial assistance.
2. **Commercial Banks:** They form the most important class of lenders in the money market. They also borrow from the central bank directly or indirectly. The money that they lend comes from the public in the form of deposits repayable on demand. These funds are invested in various forms of assets. These assets which are considered the secondary reserve for the bank are closely linked with the money market.
3. **Institutional Investors:** They include savings banks, insurance companies, trust companies and investment trusts. The portion of their funds kept invested in liquid assets finds its way into the money market.
4. **Private Individuals, Partnerships and Companies:** Normally this group may not be interested in short-term funds. If the interest rates become attractive, they may divert a portion of their surplus funds to the money market.

   The borrowers in the money market must satisfy certain conditions regarding the paper they offer for discounting. "The paper must be absolutely liquid, easily realisable and short of maturity." These conditions are satisfied by bill brokers and dealers in stock exchange.

Characteristics of a Developed Money Market

Professor S.N. Sen has described the characteristics of a developed money market in his well-known study Central Banking in Undeveloped Money Markets. The absence of one or more of these conditions will make a particular money market an undeveloped one. In every country of the world, some type of money market exists. While some of these are very highly developed, a good many are still undeveloped. There are many basic requisites which are necessary for the evolution of a developed money market:

(a) **Highly Organised Commercial Banking System:** A fully developed money market is characterised by the presence of a highly organised commercial banking system while in an undeveloped money market the banking system is undeveloped. The commercial banks are the most important suppliers of short-term funds and, therefore, any policy they follow regarding loans and advances and investments will have repercussions on the entire money market.

(b) **Presence of a Central Bank:** The second essential feature of the organisation of a developed money market is the presence of a central bank. Just as a State cannot exist and function properly without a head, so also a money market cannot function properly without a central bank. The central bank keeps the cash reserves of all commercial banks and comes to their rescue and the money market as a whole in times of difficulties by rediscounting eligible securities. In times of emergency and crisis, the central bank enables the money market to convert near-money into cash. Besides, it performs a valuable service through open-market operations when it absorbs surplus cash during off-seasons and provides additional liquidity in times of financial stringency. Thus the central bank is the leader of the money market, as well as its controller and guide. Without an efficient central bank, a developed money market cannot exist. In an undeveloped money market, either the central bank does not exist or is in its infancy without adequate capacity to influence and control the money market.

(c) **Availability of Proper Credit Instruments:** An effective money market will require a continuous supply of highly acceptable and, therefore, negotiable securities such as bills of exchange, treasury bills, short-term government bonds, etc. At the same time, there should be a number of dealers in the money market who should buy and sell these securities. Without their presence, there cannot be any competition or "life" in the money market. Thus the availability of adequate short-term assets and the presence of dealers and brokers to deal in them are essential conditions for the evolution of an organised and developed money market. An undeveloped money market, on the other hand, is characterised by the absence of sufficient short-term credit instruments as well as dealers and brokers to deal in them.

(d) **Existence of a Number of Sub-markets:** The fourth essential condition for the evolution of a developed money market is the organisation of the money market into a number of sub-markets, each specialising in particular type of short-term assets. Each type of short-term asset-depending upon the nature of the asset and period of maturity involved-is dealt within a separate market. While a developed money

market consists of a number of sub-markets each specialising in a particular type of short-term asset, an undeveloped market does not possess all the important and essential sub-markets particularly the bill market. Besides, there is no coordination between the different sections of the money market in an undeveloped money market.

(e) **Availability of Ample Resources:** The fifth essential condition for a developed money market is the availability of ample resources to finance the dealings in the various sub-markets. These resources generally come from within the country but it is also possible that foreign funds may also be attracted. While developed money markets, like London and New York, attract funds from all over the world, undeveloped money markets do not attract foreign funds mainly because of political instability and absence of stable exchange rates.

Apart from these above important factors which are responsible for the evolution of a developed money market over a number of years, there should be many other contributory factors also, such as a large volume of international trade leading to the system of bills of exchange, industrial development leading to the emergence of a stock market, stable political conditions, absence of discrimination against foreign concerns, and so on.

It is difficult to come across many developed money markets. London money market is the best example of such a market, for all the characteristics of a developed money market are to be found there. The Indian money market is a good example of an undeveloped money market.

Usefulness of a Developed Money Market

The money market is an important institution in a modern economy and it has influenced profoundly industrial and commercial developments:

(a) **In Financing Industry and Commerce:** In the first place, the money market is of very great help in financing industry and commerce. Industries are helped in their working capital requirements through the system of finance bills, commercial paper, and so on. It has played a very important part in the financing of trade and commerce. Both internal as well as international trade is normally financed through the system of bills of exchange which are discounted by the bill market.

(b) **Investment of Short-term Funds:** The money market plays a very important role in providing necessary assets for the investment of short-term funds of commercial banks. Commercial banks find such assets in the call money market as well as in the bill market. Thus, the money market offers the commercial banks a very good means of temporarily employing their funds in liquid or near-money investments.

(c) **Help to the Central Bank:** The money market is of great help to the central bank of the country. For one thing, the money market and short-term rates of interest which prevail there serve as a good barometer of monetary and banking conditions in the country and thus provide a valuable guide to the determination of central banking policy. For another, the developed money market being a highly integrated structure enables the central bank to deal with the most sensitive of the sub-markets so that the influence of the operation of the central bank may spread to other sections also.

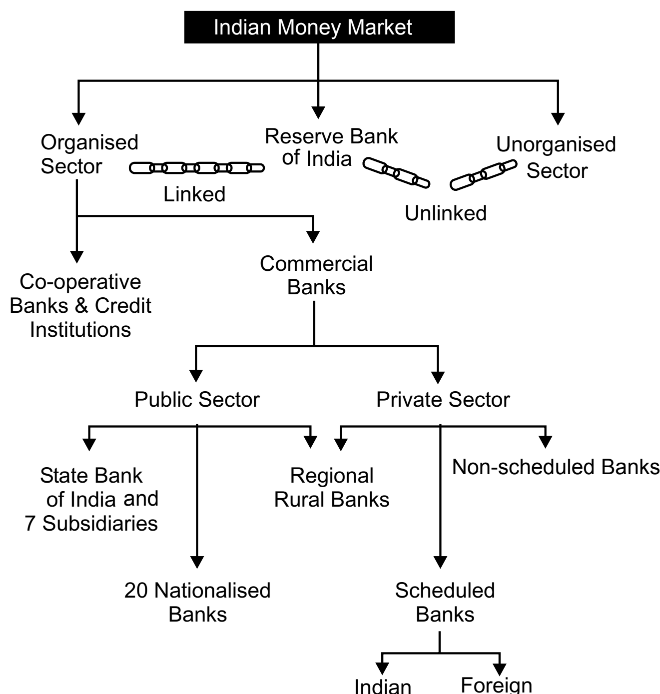
(d) **Help to the Government:** Lastly, the money market helps the government. The money market supplies the government with necessary short-term funds through the treasury bills.

Thus, a developed money market is of great assistance to industry and commerce, to the commercial banking system, to the central bank of the country and to the government.

Structure of the Money Market

The Indian money market is composed of two categories of financial agencies: (1) Organised, and (2) Unorganised. The organised sector contains, well established, scientifically managed financial institutions comprises: (a) The Reserve Bank of India, (b) The State Bank of India and its associate banks, (c) Joint-stock commercial banks, (d) Exchange banks, (e) Co-operative banks, (f) Development banks. The Reserve Bank of India is the supreme monetary and banking authority in the country. It has the responsibility to control the banking system in the country. It keeps the reserve of all commercial banks and hence is known as the "Reserve Bank." There are joint-stock commercial banks. 91 % of the banking institutions are in the public sector. There are foreign exchange banks in the country. There are cooperative banks. There are also post office savings banks which mobilises the savings of small holders. Thus, the organised sector of money market is well developed.

The unorganised sector contains agencies which have diverse policies, lack of uniformity and consistency in the lending business. The unorganised sector includes indigenous bankers, money lenders, nidhis and chitfunds. Money-lenders and indigenous bankers provide about 50 percent of rural finance. There are thousands of chitfunds operating on a big or small scale in many places in India. This sector is unorganised because its activities are not controlled and co-ordinated by the Reserve Bank of India.



Characteristics of Indian Money Market

The Indian money market is an under-developed money market. It is loosely organised and suffers from many weaknesses. It is divided into two parts, namely, organised and unorganised sectors. The following are the important characteristics of Indian market:

(a) The Indian money market does not possess a highly organised banking system, necessary for the successful working of a money market.

(b) It does not possess an adequate and continuous supply of short-term assets, such as the bills of exchange, treasury bills or short-term government bonds etc.

(c) There are no dealers in short-term assets in India, who may act as intermediaries between the government and the banking system.

(d) The Indian money market does not contain the very essential sub-markets such as the acceptance market, commercial bill market etc. A well developed call money market, however, exists in India. But acceptance houses and discount houses are not in existence in India.

(e) There is no proper co-ordination between the different sections of the money market. This is so because the inter-connection between the different sections of the money market is often loose and un-co-ordinated. Thus, the money market structure is unorganised and un-co-ordinated.

(f) There is no uniformity in the interest rates which vary considerably, among the different financial institutions as well as centres. Money-lenders especially charge exorbitant rates of interest.

(g) The Indian money market does not attract foreign funds as the London money market does. Thus, the Indian money market lacks international status.

(h) The Reserve Bank does not possess adequate capacity and power to influence and control the entire money market. It has no adequate control over the policies and functioning of the unorganised part of the money market.

Thus, the Indian money market lacks most of the characteristics of a well-developed market. It is very much undeveloped and cannot be compared with advanced money markets in the world. The London money market is regarded as the most developed money market as it possess all the characteristics of a well-developed money market. The Indian money market is inadequate to meet the financial needs of the country. It is a "money market of a sort where banks and other financial institutions lend or borrow for short-periods." Thus, the Indian money market is not a perfect one. It is unbalanced and loose. It is a restricted market. It is narrow-based with limited number of participants. It is disintegrated, ill-developed, ill-liquid, shallow and repressed.

Defects of Indian Money Market

The money market provides funds to finance production and distribution. It helps to promote economic growth of the country. A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. The central bank controls and

regulates the money supply in the country through the money market. But, unfortunately, the Indian money market is inadequately developed, loosely organised and suffers from many weaknesses. The following are the major defects of the Indian money market:

1. **Loose and Disjointed Structure:** The Indian money market consists of an organised sector and an unorganised sector. The organised sector consists of modern well-organised and scientifically operating financial institutions. The unorganised sector lacks scientific organisation. It is stagnant and ill-organised. The existence of unorganised money market is an important weakness of the Indian money market. The unorganised sector consists of indigenous bankers, money-lenders, nidhis, chitfunds etc., This unorganised sector acts independently. It carries on business on traditional lines. It follows its own rules of banking and finance. It does not submit to the control and regulation of the Reserve Bank. There is little contract, co-ordination and co-operation between the unorganised sector and the organised sector. Thus, the Indian money market is unbalanced and loose. In such conditions, it is difficult for the Reserve Bank to ensure uniform and effective implementation of its monetary policy in both the sectors.
2. **Wasteful Competition:** Wasteful competition exists not only between the organised and unorganised sectors, but also among the members of the two sectors. The relations between the various members of the money market are not cordial. They are loosely connected with each other and generally, follow separatist tendencies. For example, even today, the State Bank of India and other commercial banks looks down upon each other as rivals. Similarly, competition exists between the Indian commercial banks and foreign exchange banks.
3. **Absence of All-India Money Market:** Indian money market has not been organised into a single integrated all-India money market. It is divided into small segments mostly catering to the local financial needs. For example, there is little contact between the money markets in the bigger cities like Mumbai, Chennai and Kolkata, and those in smaller cities.
4. **Shortage of Capital:** Indian money market, generally, suffers from the shortage of capital funds. The availability of capital in the money market is insufficient to meet the needs of trade and industry in the country.
5. **Inadequate Banking Facilities:** Indian money market is inadequate to meet the financial needs of the economy. Although there has been rapid expansion of bank branches in recent years, yet vast rural areas still exist without banking facilities. As compared to the size and population of the country, the banking institutions are not enough.
6. **Seasonal Shortage of Funds:** India is primarily an agricultural country. There are two seasons in agriculture namely, busy season and slack season. During the busy season, from November to June, there will be excess demand for credit or funds for carrying on the harvesting and marketing operations in agriculture. But there will be scarcity of funds. As a result, the interest rates will rise in this period. But during

the slack season, from July to October, the demand for credit will be less. As a result, the interest rates will sharply decline. Thus, there will be wide fluctuations in the interest rates from one period of the year to another.

7. **Disparity in Interest rates in Different Centres:** There is clear disparity in money rates of interest from place to place and from institution to institution. Different interest rates exist at the same time. Close relationship does not exist between the money market rates and the bank rates. There is also difference in the interest rates of the two principal financial centres, namely, Mumbai and Kolkata. There are several rates of interest and they do not react to a change in Bank Rate. This is due to the fact that funds do not move from one financial centre to another. Disparities in the interest rates adversely affect the smooth and effective functioning of the money market.
8. **Undeveloped Bill Market:** The existence of a well-organised and well-developed bill market is essential for the proper and efficient working of money market. Unfortunately, inspite of the serious efforts made by the Reserve Bank, the bill market in India has not yet been fully developed. As a result, the short-term bills form a smaller proportion of the bank finance in India. Besides, the absence of developed bill market has reduced the liquidity of the Indian money market.
9. **Inelasticity and Instability:** The Indian money market is inelastic as well as unstable. It is a restricted market. It is narrow-based with a limited number of participants. They are not in a position to effectively mobilise funds. The supply of funds do not increase in proportion to the demand.
10. **Absence of Sub-Markets:** Sub-markets like discount houses, acceptance houses, bill brokers etc., do not exist in the Indian money market. Eventhough a call market exists, it is restricted mainly to inter bank borrowing, and it is not well-developed.
11. **Insensitive to International Influences:** Institutions that carry on foreign exchange business are few in number in our money market. The Indian money market, due to certain limitations, does not attract foreign funds. It has little contacts with foreign money markets. But in recent years, the Indian financial sector has become more global. The flow of foreign exchange has increased. The Indian money market has become more sensitive to international influences.

Measures for Improvement of the Money Market

The Reserve Bank occupies the highest place in the money market. It is the financial or monetary authority and is regarded as an apex institution. The Reserve Bank of India, from time to time, has taken various measures to remove or correct some of the existing defects and to develop a sound money market in the country. The following are the important measures or steps taken by the Reserve Bank of India:

1. A number of measures have been taken to improve the functioning of the indigenous banks. These measures include: (a) their registration, (b) keeping and auditing of accounts, and (c) providing financial accommodation through banks.

2. The Reserve Bank has taken several steps to remove the differences which existed between the different sections of the money market. All banks in the country have been given equal treatment by the Reserve Bank as regards licensing, opening of branches, the types of loans to be given etc. The discrimination between foreign and Indian banks does not exist now.
3. In order to develop a sound money market, the Reserve Bank has taken measures to amalgamate and merge banks into a few strong banks. Encouragement is also given to the expansion of banking facilities in the country.
4. To develop the bill culture in the money market, the Reserve Bank introduced two schemes: (a) The Bill Market Scheme, 1952 and (b) The New Bill Market Scheme, 1970.
5. The Reserve Bank introduced a "Lead Banking Scheme" in 1969 to eliminate banking deficiencies in rural areas.
6. Steps have been taken to establish relations between indigenous bankers and commercial banks.
7. The Reserve Bank has taken steps to reduce considerably the differences in the interest rates between different sections of the money market as well as different centres of the money market and at different times. The interest rates are deregulated and banking and financial institutions have the freedom to determine and adopt market-related interest rates.
8. Reserve Bank has been able to reduce considerably monetary shortages through open market operations.
9. Steps have been taken to implement the recommendations of working group under the chairmanship of Mr. N. Vaghul and Chakravarty committee.
   (a) Several new money market instruments were introduced to provide suitable instruments to the investors. 182 days and 364 days Treasury Bills were introduced to widening the scope of the short-term money market. In 1992-93, Certificate of Deposits, commercial paper were introduced. Certificate of deposits provide and avenue for investment at better rates in the banking sector. Commercial paper introduced in 1989 is a short-term negotiable money market instrument. Reserve Bank introduced two more Treasury Bills in 1997, (i) 14-day Intermediate Treasury Bills, and (ii) a new category of 14-day Treasury bills.
   (b) In April 1988, the Discount and Financial House of India Limited was established with a view to provide liquidity to money market instruments. Discount and Finance House of India is now the apex body in the Indian money market. It has developed a secondary market in government securities by buying and selling them.
10. In 1991, the commercial banks and public sector financial institutions were permitted to set up "Money Market Mutual Funds" (MMMF). The shares or units of money market mutual funds are to be sold only to individuals unlike the other mutual funds. The purpose of this fund is to bring money market instruments, like treasury bills, within the reach of individuals. In 1995, the Reserve Bank permitted private sector institutions to set up Money Market Mutual Funds.

11. The scheme of Inter-Bank Participation (IBP) has been introduced by the Reserve Bank in 1988.
12. Access to bill rediscounting market has been increased by selectively increasing the number of participants in the market.

As a result of various measures taken by the Reserve Bank of India, the Indian money market has shown signs of notable development in many ways. It has become more vibrant and advanced. The present position of the money market is stated below:

1. It is becoming more and more organised and diversified.
2. The government trading in various instruments like 364-Day Treasury Bills, commercial bills and commercial paper has increased.
3. The volume of inter-bank call money, short notice money and term money transactions has grown significantly.
4. At present Discount and Finance House of India is also participating in the money market, both as a lender and borrower of short-term funds.
5. Banks and non-banking financial institutions are providing "factoring services."

Suggestions to Remove Defects in the Indian Money Market

In view of the various defects in the Indian money market, the following suggestions have been made for its proper development:

1. The activities of the money-lenders, indigenous bankers, and chit funds should be brought under the effective control of the Reserve Bank of India.
2. Hundies used in the money market should be standardised and written in the uniform manner in order to develop an all-India money market.
3. Banking facilities should be expanded, especially in the unbanked and neglected areas.
4. Discounting and rediscounting facilities should be expanded in a big way to develop the bill market in the country.
5. For raising the efficiency of the money market, the number of clearing houses in the country should be increased and their working improved.
6. Adequate and easy remittance facilities should be provided to the businessmen to increase the mobility of capital.
7. As per recommendation of the Narasimham Committee, well-managed non-banking financial institutions, like leasing and Hire-purchase companies, Merchant Banks, Venture capital companies should be allowed to operate in the money market.
8. The Reserve Bank should encourage to open Discount and Acceptance Houses.
9. Harmony between sub-markets and co-ordination of their activities must be achieved.
10. More participants should be allowed into the money market and more instruments should be evolved and introduced in the money market. This will develop the secondary market.

In recent years, the Indian money market has started becoming more deep and wide owing to a number of innovative measures undertaken by the authorities towards its structural reforms and the financial liberalisation. We require a well-developed money market to make our plans a success. A well organised and developed market can help to achieve economic growth and stability.

Recent Innovations in the Money Market: Since a long time the Indian money market has been characterised as disintegrated, ill-developed, ill-liquid, shallow and repressed. The Seventh Plan period, however, witnessed a remarkable improvement in the whole situation and working of the money market in the country. The authorities positively accepted certain major recommendations of the Chakravarty Committee and Vaghul Committee in this context and enthusiastically acted upon in due course of time. In fact, the celebrated reports of these two committees blew the air of financial liberalisation and innovation in the Indian monetary system. Consequently, during the last 3-4 years, the Indian money market has started becoming more deep and wide owing to a number of innovative measures undertaken by the authorities towards its structural reforms and the financial liberalisation.

14-day Intermediate Treasury Bills: With the discontinuance of tap treasury bills, the central government introduced the scheme of 14 day treasury bills to provide the State governments, foreign central banks and specified bodies with an alternative arrangement to invest their surplus funds. The salient features of the scheme are: (i) treasury bills would be sold only to the State governments, foreign central banks and other specified bodies with whom the RBI has an agreement for investing their temporary surplus funds; (ii) these treasury bills would be sold on a non-transferable basis for a minimum amount of Rs. 1,00,000 and in multiples of Rs. 1,00,000; (iii) these treasury bills would be repaid / renewed at par on the expiration of 14 days from the date of their issue, and (iv) the discount rate would be set at quarterly interval such that the effective yield of this instrument would be equivalent to the interest rate on the Ways and Means advances chargeable to the Central government. The total bills outstanding at end-March 2000 was Rs. 2,383 crore of which the share of State governments was 96.18 per cent.

14-Day Auction Treasury Bills: The RBI introduced 14-day auction treasury bills on a weekly basis with effect from June 6, 1997. The dual purpose of introducing these treasury bills is to facilitate the cash management requirements of various segments of the economy and to help in forming a complete yield curve for aiding in the pricing of debt instruments. The 14-day auction treasury bills do not devolve on the RBI unlike the 91-day treasury bills. The total issues of 14 day auction treasury bills during 1999-2000 amounted to Rs. 16,453 crore of which non-competitive bids aggregated Rs. 11,253 crore, representing 68 per cent of the total issues. The subscriptions of the RBI aggregated Rs. 1,134 crore.

91-Day Treasury Bills: Earlier there were two types of 91-day treasury bills–ordinary and ad hoc. With effect from April 1, 1997 ad hoc treasury bills were discontinued. On this day 91 day ad hoc treasury bills amounting to Rs. 38,130 crore were converted into special securities without any specific maturity. The interest on these securities was fixed at 4.6 per cent per annum.

In 1992-93 a scheme for the issue of 91-day treasury bills with the RBI participation was introduced. The cut off yields on these treasury bills were higher than the fixed discount rate of 4.6 per cent per annum on 91-day treasury bills sold on tap.

A gross amount of Rs. 8,155 crore was raised during 1999-2000 in respect of 91-day treasury bills as against Rs. 16,697 crore in the previous year. Out of the total gross amount, non-competitive bids aggregated to Rs. 2,995 crore accounting for about 36 per cent of the value of the total issues.

182-Day Treasury Bills: 182-day treasury bills were reintroduced with effect from May 26, 1999. As per the calender, notified amount for 182-day treasury bills remained constant at Rs. 100 at the fortnightly auctions held on Wednesdays preceding the non-reporting Fridays. The cut-off yield has varied within the range of 8.53 - 9.97 per cent.

364-Day Treasury Bills: 364-day treasury bills were introduced in April 1992. Since then these treasury bills are auctioned on a fortnightly basis in a regular manner. These treasury bills are not rediscountable with the RBI. However, they offer short-term investment opportunities to banks and other financial institutions. Since 364-day treasury bills constitute a safe avenue for investment, the auctions of these treasury bills have evoked good response. Gross mobilisation through issuance of 364-day treasury bills was Rs. 13,000 crore in 1999-2000 as against Rs. 10,200 crore in 1998-99. The subscription by the RBI was Rs. 2,267 crore or 17.44 per cent of the value of the total issues.

In 1999-2000, there was a relative stability in the yield on both 91-day treasury bills and 364-day treasury bills. The yield spread between these bills was rather small during the year.

The Repo Market

Repo is a money market instrument which helps in collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. Under a repo transaction, securities are sold by their holder to an investor with an agreement to repurchase them at a predetermined rate and date. Under reverse repo transaction, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.

Initially repos were allowed in the Central government treasury bills and dated securities created by converting some of the treasury bills. In order to make the repos market an equilibrating force between the money market and the government securities market, the RBI gradually allowed repo transactions in all government securities and treasury bills of all maturities. Lately State government securities, public sector undertakings' bonds and private corporate securities have been made eligible for repos to broaden the repos market.

Explaining the usefulness of repos Report on Currency and Finance 1999-2000 notes that "repos help to manage liquidity conditions at the short-end of the market spectrum. Repos have been used to provide banks an avenue to part funds generated by capital inflows

to provide a floor to the call money market. During times of foreign exchange volatility, repos have been used to prevent speculative activity as the funds tend to flow from the money market to the foreign exchange market."

The Commercial Bill Market

The commercial bill market is the sub-market in which the trade bills or the commercial bills are handled. The commercial bill is a bill drawn by one merchant firm on the other. Generally, commercial bills arise out of domestic transactions. The legitimate purpose of a commercial bill is to reimburse the seller while the buyer delays payment. In India, the commercial bill market is highly undeveloped. The two major factors which have arrested the growth of a bill market are: (i) popularity of cash credit system in bank lending, and (ii) the unwillingness of the larger buyer to bind himself to payment discipline associated with the commercial bill. Among other factors which have prevented growth of genuine bill market are lack of uniformity in drawing bills, high stamp duty on usance or time bills and the practice of sales on credit without specified time limit.

Commercial bills as instruments of credit are useful to both business firms and banks. In addition, since the drawees of the bill generally manage to recover the cost of goods from their resale or processing and sale during the time it matures, the bill acquires a self liquidating character. Finally, it is easier for the central bank to regulate bill finance. Keeping in view these considerations the RBI has made efforts to develop a bill market in this country and popularise the use of bills. Its two specific bill market schemes, however, had limited success. The old bill market scheme introduced in January 1952 was not correctly designed to develop a bill market. It merely provided for further accommodation to banks in addition to facilities they had already enjoyed. The scheme had, in fact, provided for obtaining loans on the security of bills rather than for their rediscount. In order to encourage use of bills the RBI offered loans at a concessional rate of interest and met half the cost of stamp duty incurred by banks on converting demand bills into usance bills. This scheme, however, failed to make any impact.

Not satisfied with the old scheme the RBI introduced a new bill market scheme in November 1970. It has been modified from time to time. The two noteworthy features of the new scheme are: (i) The bills covered under the scheme are genuine trade bills; and (ii) the scheme provides for their rediscounting. Even this scheme which really aimed at developing a bill market in the country has not been very successful. The major obstacle to the development of bill finance in this country is the dominant cash credit system of credit delivery where the bonus of cash management rests with banks. Absence of an active secondary market further prevented growth of the market for bills finance.

The success of the bills discounting scheme depends largely upon financial discipline on the part of borrowers. In the absence of such restraints, the RBI, in July 1992, restricted the banks to finance bills to the extent of working capital needs based on credit norms. However, in order to encourage 'bills' culture, the RBI advised banks in October 1997 that at least 25

per cent of inland credit purchases of borrowers should be through bills. Nonetheless, the outstanding amount of commercial bills rediscounted by the banks with various financial institutions was only Rs. 235 crore at end-May 2000.

The Certificate of Deposit (CD) Market

A Certificate of Deposit (CD) is a certificate issued by a bank to depositors of funds that remain on deposit at the bank for a specified period. Thus CDs are similar to the traditional term deposits but are negotiable and tradeable in the short-term money markets. In the mid-eighties, the short-term banks deposit rates were much lower than other comparable interest rates. The Vaghul Committee thus felt that the CD as a money market instrument could not be developed in this country until the situation remained unchanged. The Committee stressed that it was necessary for the introduction of the CD that the short-term bank deposit rates were aligned with the other interest rates. In 1988-89, the RBI, as a corrective measure revised upwards the rate of interest on term deposits of 46 to 90 days. Once this was done in March 1989, the RBI introduced CDs with the objective of widening the range of money market instruments and to provide investors greater flexibility in the deployment of their short-term surplus funds. The CDs could initially be issued only by scheduled commercial banks in multiples of Rs. 25 lakh (later lowered to Rs. 10 lakh) subject to the minimum size of an issue being Rs. 1 crore. Their maturity varied between three months and one year. In 1993 six financial institutions, viz., Industrial Development Bank of India, Industrial Credit and Investment Corporation of India, Industrial Finance Corporation of India, The Industrial Reconstruction Bank of India, Small Industries Development Bank of India and Export-Import Bank of India were permitted to issue CDs with a maturity period of more than one year and upto three years. CDs are issued at discount to face value and the discount rate is market determined. They are further freely transferable by endorsement and delivery. Banks pay a high interest rate on CDs. Hence holders of CDs prefer to hold them till maturity and thus secondary activity in CDs has been non-existent. There was also a lack of interest among banks in issuing fresh CDs in 1993-94. The stringent conditions in the money market in 1995-96, however, induced banks to mobilise resources on a large scale through CDs. The outstanding amount of CDs issued by the banks rose from Rs. 8,017 crore as at end-March 1995 to Rs. 21,503 crore as on June 7, 1996 but declined to Rs. 14,296 crore as on March 27, 1998. Thereafter there was a steep fall in outstanding amount of CDs and it was as low as Rs. 872 crore as on May 5, 2000. Due to the tight money market conditions, the discount rates on CDs increased sharply during 1995-96. However, since July 1996 the average discount rate on CDs has steadily declined. On June 2, 2000 effective discount rate range was 8.00–11.16 per cent per annum. To bring CDs at par with other instruments such as CPs and term deposits, the minimum maturity of this instrument was reduced to 15 days in April 2000 from 3 months earlier.

The Commercial Paper Market

The Commercial Paper (CP) is a short-term instrument of raising funds by corporates. It is essentially a sort of unsecured promissory note sold by the issuer to a banker or a security house. The issuance of CP is not related to any underlying self-liquidating trade. Therefore, maturity of this instrument is flexible. Usually borrowers and lenders adopt the maturity of a CP to their needs. Highly rated corporates which can obtain funds at a cost lower than the cost of borrowing from banks are particularly interested in issuing CPs. Institutional investors also find CPs as an attractive outlet for their short-term funds. The Vaghul Committee had strongly recommended the introduction of CPs in the Indian money market. In its observations on this instrument, the Committee had stated, "the issue of commercial paper imparts a degree of financial stability to the system as the issuing company has an incentive to remain financially strong. The possibility of raising short-term finance at relatively cheaper cost would provide an adequate incentive for the corporate clients to improve the financial position and in the process the financial health of the corporate sector should show visible improvement."

Following the recommendations of the Vaghul Committee, the CP was introduced in the Indian money market in January 1990. The CP can be issued by a listed company which has a working capital of not less than Rs. 5 crore. With maturity ranging from three months to six months they would be issued in multiples of Rs. 25 lakh (later reduced to Rs. 25 lakh) subject to the minimum size of an issue being Rs. 1 crore (later reduced to Rs. 25 lakh). The company wanting to issue CP would have to obtain every six months a specified rating from an agency approved by the RBI. CPs would be freely transferable by endorsement and delivery. According to the RBI's guidelines for the issue of CP, a company will have to obtain P2 rating from Credit Rating Information Services of India Ltd. (CRISIL) or A2 rating from Investment Information and Credit Rating Agency of India Ltd. (ICRA). It has also to maintain the current ratio of 1.33:1 to be eligible to issue CP. Maturity period of CP so far ranged from 3 months to 6 months and the effective interest rates were in the range of 9.35 to 20.9 per cent per annum. Easy liquidity conditions gave fillip to the issue of CPs during 1996-97 and the outstanding stocks of CPs rose from a historical low level of Rs. 71 crore in April 1996 to Rs. 7,127 crore as on July 15, 2000 with the typical effective discount rate range being 9.35–11.65 per cent annum.

Money Market Mutual Funds

A scheme of Money Market Mutual Funds (MMMFs) was introduced by the RBI in April 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors. As the initial guidelines were not attractive, the scheme did not receive a favourable response. Hence, with a view to making the scheme more flexible, the RBI permitted certain relaxations in November 1995. The new guidelines allow banks, public financial institutions and also the institutions in the private sector to set up MMMFs. The ceiling of Rs. 50 crore on the size of MMMFs stipulated earlier, has been withdrawn. The prescription of limits on investments in individual instruments by MMMF has been generally

deregulated. Since April 1996, MMMFs are allowed to issue units to corporate enterprises and others. During 1996-97 the scheme of MMMFs was made more flexible by bringing it on par with all other mutual funds by allowing investment by corporates and others. The scheme was later on made more attractive to investors by reducing the lock-in period from 46 days to 15 days. The scheme was further liberalised in 1997-98 and the MMMFs were permitted to make investments in rated corporate bonds and debentures with residual maturity of upto one year. Resources mobilised by the MMMFs could earlier be invested exclusively in call/notice money, treasury bills, CDs, CPs, commercial bills arising out of genuine trade/commercial transactions and government securities having an unexpired maturity upto one year. The prudential measure that the exposure of MMMFs to CPs issued by an individual company should not exceed 3 per cent of the resources of the MMMF has been retained.

Capital Market

The term "Capital Market" is used to describe the institutional arrangements for facilitating the borrowing and lending of long-term funds. Usually, stress is laid on the markets for long-term debt and equity claims, government securities, bonds, mortgages, and other instruments of long-term debts. Thus, the capital market embraces the system through which the public takes up long-term securities, either directly or through intermediaries. It consists of a series of channels through which the savings of the community are mobilised and made available to the entrepreneurs for undertaking investment activities.

Conventionally, short-term credit contracts are usually classified as money market instruments, while long-term debt contracts and equities are regarded as capital market instruments. In practice, however, there is a thin line of demarcation between the money market and the capital market, because quite often, the same institutions participate in the activities of both the markets, and there is flow of funds between the two markets.

Classification of Indian Capital Market

The Indian capital market is divided into the gilt-edged market and the industrial securities market. The gilt-edged market refers to the market for government and semi-government securities, backed by the Reserve Bank of India. The securities traded in this market are of stable value. They are mostly demanded by banks and other institutions.

The industrial securities market refers to the market for shares and debentures of old and new companies. This market is further divided into the new issue market and the old market, meaning the stock exchange. The "new issue market" refers to the raising of new capital in the form of shares and debentures. The old capital market deals with securities already issued. Both markets are equally important.

The capital market is also classified into primary capital market and secondary capital market. The primary market refers to the new issue market. The secondary capital market refers to the market for old or already issued securities. The secondary capital market is composed of industrial security market or the stock exchange.

Importance of Capital Market

An efficient capital market is an essential pre-requisite for industrial and commercial development of a country. An organised and well-developed market operating in a free market economy ensures the best possible co-ordination and balance between the flow of savings on the one hand and the flow of investment leading to capital formation on the other. It also directs the flow of savings into most profitable channels and thereby ensures optimum utilisation of financial resources. The importance of capital market in the process of economic development of a country can be described as below:

1. **Mobilising Savings:** The capital market plays a vital role in mobilising savings to put it in productive investment, so that the development of trade, commerce and industry could be facilitated. In this process the capital market helps in the process of capital formation and hence the economic development. The capital market acts as a bridge, between savers and investors.
2. **Stability in Value:** In case of a developed capital market, the experts in banking and non-banking intermediaries put in every effort in stabilising the values of stocks and securities. This process is facilitated by providing capital to the needy at a lower rate of interest and by cutting down the speculative and unproductive activities.
3. **Encouragement to Economic Growth:** The process of economic growth is made easier through the capital market. The various institutions of the capital market give quantitative and qualitative direction to the flow of funds. The proper flow of funds leads to the development of commerce, trade and industry.
4. **Inducement to Savings:** Savings are the backbone of any nation's economic development. If capital markets are developed in less developed areas, people will get induced to save more because savings are facilitated by banking and non-banking financial intermediaries.

   Thus, it is clear that the capital market is the life-blood of economic development of a country. If the capital market is not developed, it will lead to misuse of financial resources. The capital market plays a significant role in diverting the wrongful use of resources to their rightful use.

Functions of Capital Market

The major functions performed by a capital market are as follows:

(a) Mobilisation of financial resources on a nation-wide scale.

(b) Securing the foreign capital and know how to fill up the deficit in the required resources for economic growth at a faster rate.

(c) Effective allocation of the mobilised financial resources by directing the same to projects yielding highest yield or to the projects needed to promote balanced economic development.

Structure of Indian Capital Market

The capital market in India may be classified into two sectors (a) organised, and (b) unorganised sector. In the organised sector of the capital market demand for long-term capital comes from corporate enterprises, public sector enterprises, government and semi-government institutions. The sources of supply of funds comprise individual investors, corporate and institutional investors, investment intermediaries, financial institutions, commercial banks and government. In India, even the organised sector of capital market was ill-developed till recently because of the following reasons:

(a) Agriculture was the main occupation which did not lend itself to the floatation of securities.

(b) The foreign business houses hampered the growth of securities market.

(c) Various restrictions have been imposed on the investment pattern of various financial institutions.

(d) The investment habit of individuals has been very low.

The unorganised sector of the capital market consists of indigenous bankers and private money-lenders. The main demand in the unorganised capital market comes from the agriculturists, private individuals for consumption rather than production and even small traders. The supply of money-capital comes, usually from own resources of money-lenders and falls short of the requirements.

Components of Indian Capital Market

The following are the main components of the Indian capital market:

1. New Issues Market.
2. Stock Market.
3. Financial Institutions.

1. **New Issues Market:** The new issues market represents the primary market where new shares or bonds are offered. Both the new companies and the existing ones can raise capital on the new issue market. The prime function of the new issues market is to facilitate the transfer of funds from the willing investors to the entrepreneurs setting up new corporate enterprises, going in for expansion, diversification, growth or modernisation. Besides, helping the corporate enterprises in securing their funds, the new issues market channelises the savings of individuals and others into investments. The availability of financial resources for corporate enterprises, to a great extent, depends upon the status of the new issues market of the country. Successful issues of new securities is a highly specialised activity and requires both experience and skill. There are a number of methods of marketing new issues of securities.
2. **Secondary Market or Stock Market:** Stock market represents the secondary market where existing shares and debentures are traded. Stock exchange provides an organised mechanism of purchase and sale of existing securities. The stock

exchanges enable free purchase and sale of existing securities. The stock-exchanges enable free purchase and sale of securities as commodity exchange allow trading in commodities.

3. **Financial Institutions:** Special financial institutions are the most active constituents of the Indian capital market. Such organisations provide medium and long-term loans repayable on easy instalments to big business houses. Such institutions help in promoting new companies, expansion and development of existing companies and meeting the financial requirements of companies during economic depression. After independence, a number of financial institutions have been set up at all India and regional levels for accelerating the growth of industries by providing financial and other assistance. The following are the main financial institutions that are most active constituents of the Indian capital market:
   (a) The Industrial Finance Corporation of India Ltd.
   (b) The Industrial Credit and Investment Corporation of India.
   (c) State Financial Corporations.
   (d) The Industrial Development Bank of India.
   (e) National Industrial Development Corporations.
   (f) Unit Trust of India.
   (g) Life Insurance Corporation of India.
   (h) Nationalised Commercial Banks.
   (i) Merchant Banking Institutions.
   (j) The Credit Guarantee Corporation of India.

Recent Trends in the Capital Market

Capital market is the market for long-term funds, just as the money market is the market for short-term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending medium-term and long-term funds. It does not deal in capital goods but is concerned with the raising of money capital for purpose of investment. A well-developed capital market is necessary for the economic development of a country. The Indian Capital Market was not properly developed before independence. But since independence the Indian capital market has been broadening significantly and the volume of saving and investment has shown steady improvement. Many institutional innovations have been made, liberalisation has been accepted and private sector entered all avenues of trade, commerce and industry. Capital issues control has been abolished. Stock Exchange Board of India has taken the challenge of regulating the capital market. New financial instruments and players entered the market. Leasing companies, hire-purchase companies, venture capital companies were set up in the country.

The recent trends in the capital market can be discussed under the following heads:

1. Growth of the Capital Market.

2. New Financial Instruments.
3. New Specialised Financial Institutions.
4. Financial Services.
5. Regulation of Capital Market.

1. **Growth of the Capital Market:** Since independence and particularly after 1951, the Indian capital market has grown in size. The volume of saving and investment in the country has shown steady improvement. All types of encouragement and tax relief exist in the country to promote savings. Besides, many steps have been taken to protect the interests of investors. The primary market and secondary market have grown. A very important indicator of the growth of the capital market is the growth of joint-stock companies. In 1951, there were about 28,500 companies, both public and private limited companies, with a paid-up capital of Rs. 775 crores. But in 1997, there were about 64,000 companies, with a paid-up capital of Rs. 1,00,000 crores. In the last two decades, the capital market in India has witnessed significant developments. The volume of capital market transactions have increased sharply and its functioning has been diversified. The number of shareholders runs into several millions, indicating the growth of the cult of equity.
2. **New Financial Instruments:** The corporate sector has devised new instruments for raising funds from the market. New instruments include zero interest bonds, equity warrant, secured premium note, deep discount bond and partly convertible debentures. Joint-stock companies could raise more and more finance by the issue of new instruments. These new instruments widened the capital market. The Government of India has introduced into the market (1) 14-day Intermediate Treasury Bills in April 1997, (2) A new category of 14-day Treasury Bills in 1977, (3) Commercial Paper, (4) Dated Government Securities.
3. **New Specialised Financial Institutions:** The Government of India has set up a series of financial institutions to provide funds to the large industrial sector. The important financial institutions established are the Industrial Finance Corporation of India, the Industrial Investment and Credit Corporation of India, the Industrial Development Bank of India. The specialised financial institutions are called development banks. They have been underwriting the shares and debentures issued by companies. They have been subscribing to the share capital of companies.

   Besides development banks, non-banking finance companies have come into existence all over the country and have been making rapid progress. They advance loans to wholesale and retail traders, small-scale industries and self employed persons. Hire-purchase companies, venture capital companies, finance corporations are all non-banking finance companies.

   Holding Corporation of India, Infrastructure Leasing and Financial Services Ltd., The Credit Rating Information Services of India, Housing Development Corporation of India have been set up in the country.

4. **Financial Services:** The entry of service sector in the capital market is adding new dimension in the market. The financial services offered are:
   (1) Venture Capital, (2) Factoring Services, (3) Leasing, (4) Merchant Banking, (5) Mutual Funds.
5. **Regulation of Capital Market:** Stock Exchange Board of India has been set up in 1988 to lay guidelines, and supervise and regulate the working of capital market. SEBI in consultation with the Government has taken a number of steps to introduce improved practices and greater transperancy in the capital markets in the interest of the investing public and the healthy development of the capital markets. SEBI has the power to control and regulate the new issue market as well as the old issues market. Since 1992, the Government has allowed Indian companies access to international markets through Euro-equity shares.

Comparison of Money Market and Capital Market

There are important similarities and differences between money market and capital market.

Similarities: The money market and capital market have certain similarities and inter relations. They are:

1. **Complementary:** The money market and the capital market are complementary to each other and are not competitive. The difference between the two is only of degree rather than of kind.
2. **Same Institutions:** Certain institutions operate in money as well as capital markets. For example, commercial banks operate in money market as well as in capital market. They have started giving long-term loans also in recent years.
3. **Interdependence:** Money market and capital market are interdependent. The activities and policies of one market have their impact on those of the other. For example, the increased demand for funds in the capital market also raises the demand and interest rates in the money market. Similarly, the monetary policy also influences the activities of the capital market.

Differences: Money market is distinguished from capital on the basis of the maturity period, credit instruments and the institutions.

1. **Maturity Period:** The money market deals in the lending and borrowing of short-term finance. But the capital market deals in lending and borrowing of long-term finance.
2. **Credit Instruments:** The main credit instruments of the money market are trade bills, promissory notes and Government papers or bills. On the other hand, the main instruments used in the capital market are stocks, shares, debentures, bonds and securities of the Government.
3. **Nature of Credit Instruments:** The credit instruments dealt within the capital market are more heterogeneous than those in money market.

4. **Institutions:** Important institutions operating in the money market are central bank, commercial banks, acceptance houses, non-banking financial institutions, bill brokers etc. Important institutions in the stock market are stock exchanges, commercial banks, development banks and non-banking financial institutions such as insurance companies, mortgage banks and building societies.
5. **Purpose of Loans:** The money market meets the short-term credit needs of business. It provides working capital to the industrialists. The capital market, on the other hand, meets the long-term needs of the industrialists and provides fixed capital to buy land, machinery etc.
6. **Risk:** The degree of risk is small in the money market. The risk is much greater in capital market.
7. **Relation with Central Bank:** The money market is closely and directly linked with the central bank of the country. The capital market feels central bank's influence, but mainly indirectly and through the money market.
8. **Market Regulation:** In the money market, commercial banks are closely regulated. In the capital market, the institutions are not much regulated.
9. **Basic Role:** The basic role of money market is that of liquidity adjustment. The basic role of capital market is that of putting capital to work preferably to long-term and productive employment.

Conclusion

From the above discussion, it is clear that the money and capital markets of a country play an important part, as they control the flow of short-term and long-term funds in the country. The money market determines the volume of working capital available to business and industrial units and also the price level. Likewise, the capital market determines the supply of long-term capital for the industrial units. The study of the monetary system, therefore, is very useful.

Questions for Discussion

1. What is meant by the money market ? Explain its structure and functions.
2. What are the chief characteristics of the Indian money market? Suggest some practical methods of improving its organisation.
3. What are the defects of the Indian money market ? Discuss the efforts made by the Reserve Bank of India to develop the Indian money market.
4. What is Capital Market? Discuss the objectives, importance and functions of capital market.
5. Give main points of distinction between money market and capital market.

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STRUCTURE OF BANKING IN INDIA

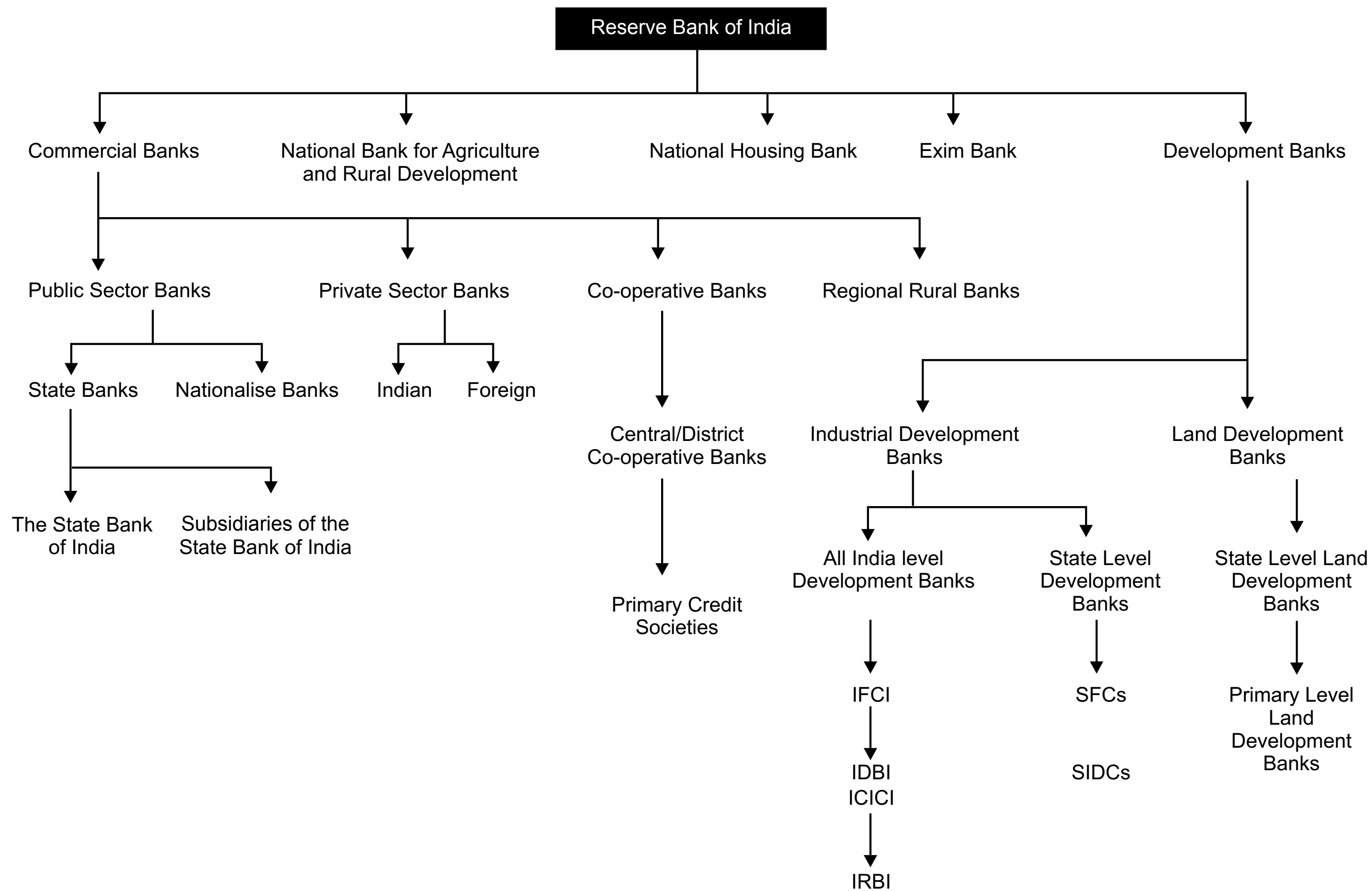
INTRODUCTION

At the time of independence Indian banking system was not sound. There were hundreds of small banks under unscrupulous managements. Hence, in 1949 two major actions were taken which were very important from the point of view of structural reforms in the banking sector. First, the Banking Regulation Act was passed. It gave extensive regulatory powers to Reserve Bank of India over the commercial banks. Another development of no less importance was the nationalisation of the RBI. These two major developments in the immediate Post-Independence period proved to be the turning points in India's commercial banking.

Indian banking system comprises of both organised and unorganised banks. Unorganised banking includes indigenous bankers and village money-lenders. Organised banking includes Reserve Bank of India, Commercial Banks, (including Foreign Banks), Development Banks, Exim Bank, Co-operative Banks, Regional Rural Banks, National Bank for Agriculture and Rural Development, Land Development Banks etc.

1. Indigenous Banks

From very ancient days, India has had banking of some type, known as indigenous banking. Indigenous banking peculiar to India had been organised in the form of family or individual business. In different parts of the country the indigenous bankers have been called by different names, such as Shroffs, Sahukars, Mahajans, Chettis, Seths, Kathiwals etc. They vary in size from petty money lenders to substantial shroffs who carry on large and specialised banking business. They are to be found in all parts of the country- in large towns and cities and villages.


Reserve Bank of India
Commercial Banks
National Bank for Agriculture and Rural Development
National Housing Bank
Exim Bank
Development Banks
Public Sector Banks
Private Sector Banks
Co-operative Banks
Regional Rural Banks
State Banks
Nationalise Banks
Indian
Foreign
Central/District Co-operative Banks
Industrial Development Banks
Land Development Banks
The State Bank of India
Subsidiaries of the State Bank of India
Primary Credit Societies
All India level Development Banks
State Level Development Banks
State Level Land Development Banks
IFCI
SFCs
Primary Level Land Development Banks
IDBI
ICICI
SIDCs
IRBI

Meaning

Indigenous bankers are individuals or private firms which receive deposits and give loans and thereby operate as banks. Since their activities are not regulated, they belong to the unorganised segment of the money market. The indigenous bankers have been engaged in the banking business in both ancient and medieval periods. They received set back with the introduction of modern banking after the arrival of the British. Over the past two and a half decade with the growth of commercial and cooperative banking the area of the operations of the indigenous bankers has contracted further. Still there are a few thousand indigenous bankers particularly in the western and southern parts of the country who are engaged in traditional banking business. The volume of their credit operations is however not known.

Groups

Indigenous bankers do not constitute a homogeneous group. Broadly they may be classified under four main sub-groups. Gujarati Shroffs, Multani or Shikarpuri Shroffs, Chettiars and Marwari Kayas. The Gujarati shroffs operate in Mumbai, Kolkata and the industrial and trading cities of Gujarat. The Marwari Shroffs are active in Kolkata, Mumbai, tea-gardens of Assam and other parts of North-East India. The Multani or Shikarpuri Shroffs are to be found mainly in Mumbai and Chennai and the Chettiars are concentrated in the South. Of the four main such groups of the indigenous bankers the Gujarati indigenous bankers are the most important in terms of the volume of business.

Types

There are three types of indigenous bankers: (a) those whose main business is banking, (b) those who combine their banking business with trading commission business, and (c) those who are mainly traders and commission agents but who do a little banking business also. The majority of the indigenous bankers belong to the second group.

Functions of Indigenous Bankers

The main functions of the indigenous bankers are as follows:

1. **Accepting Deposits:** Indigenous bankers accept deposits from the public. These deposits are of two types: (a) the deposits which are repayable on demand, and (b) the deposits which are repayable after a fixed period. The indigenous bankers pay higher rate of interest than that paid by the commercial banks.
2. **Advancing Loans:** The indigenous bankers advance loans to their customers against all types of securities, such as land, houses, crops, gold and silver. They also give credit against personal security. They finance inland trade, including the movement of agricultural commodities like sugar, oil seeds etc. But they do not grant direct loans to farmers. They give loans to farmers through money-lenders. They provide loans to small industries which cannot fulfil the necessary loan conditions of commercial banks. In recent years, they are also providing working capital to the small industrialists.

3. **Business in Hundies:** The indigenous bankers deal in hundies. They write hundies and buy and sell hundies. They also discount hundies and thereby meet the financial needs of the internal traders. They also transfer funds from one place to another through discounting of hundies.
4. **Acceptance of Valuables for Safe Custody:** Indigenous bankers accept valuables of their clients for safe custody. Some indigenous bankers provide cheque facility. They provide remittance facilities also.
5. **Non-banking Functions:** Most of the indigenous banks or bankers also carry on their non-banking business along with the banking activities. They generally have their retail trading business. They also participate in speculative activities. Sometimes, they act as agents to big commercial firms and earn commission.

Defects of Indigenous Bankers

There are, however, certain defects in indigenous banking in India. They are as follows:

1. **Mixing Banking and Non-banking Business:** The indigenous bankers, generally combine banking and non-banking business. Many of them undertake speculative activities. Their business is risky as they combine both trading and banking. This is against the principle of sound banking.
2. **Unorganised Banking System:** The indigenous banking system is highly unorganised and segmented. Different indigenous bankers operate separately and independently. They have no coordination with each other. They have no regular contact with the commercial banks. The transfer of funds is not possible in such a system.
3. **Insufficient Capital:** The indigenous bankers largely depend upon their own capital. As a result, their financial resources are insufficient to meet the demand of borrowers.
4. **Meagre Deposit Business:** The main business of the indigenous bankers is to give loans and deal in hundies. Their deposit business is meagre or very small. They have failed to tap and mobilise rural savings effectively.
5. **Defective Lending:** The indigenous bankers, generally do not follow the sound banking principles while granting loans. They provide loans against insufficient securities or even against personal securities. They also give loans against immovable properties. They also do not distinguish between short-term and long-term loans.
6. **Unproductive Loans:** The indigenous bankers do not pay attention to the purpose for which the loan is used. They also give money for unproductive and speculative activities or for paying off old debts.
7. **Higher Interest Rates:** The indigenous bankers charge very higher interest rates for the loans than those charged by the commercial banks. High rates of interest adversely affect the inducement to produce.
8. **Exploitation of Customers:** The indigenous bankers adopt all types of malpractices and exploit their customers in many ways. For example, they make unauthorised deductions from loans. They overstate the amount of the loan in the document.

9. **Discouragement to Bill Market:** The indigenous bankers also stand in the way of developing a proper bill market in the country. Bulk of their business is based on cash transactions rather than on hundies.
10. **Secrecy of Accounts:** They adopt a traditional accounting system in vernacular. The indigenous bankers keep secrecy about their accounts and activities. They neither get their accounts audited nor publish annual balance sheets. This raises suspicion in the minds of the people.
11. **No Control of Reserve Bank:** The indigenous banking business is unregulated. The Reserve Bank of India has no control over these bankers and cannot regulate their activities. In this way the indigenous banks are a great hurdle in the way of developing an organised money market in the country.

Indigenous Bankers and the Reserve Bank

Since its inception in 1935, the Reserve Bank of India has been making sincere efforts: (a) to bring the indigenous bankers under its control, (b) to integrate them with the modern banking system, and (c) to provide various central banking facilities to them. But the Reserve Bank failed to achieve success. It is unable to control the activities of the indigenous bankers. They are outside the control and influence of the Reserve Bank. The policy of the Reserve Bank would become effective only when indigenous banks are directly linked to it.

Suggestions for Reform

Various suggestions have been made to improve the functioning of indigenous banking in the country. They are:

1. The indigenous bankers should be directly linked with the Reserve Bank.
2. The indigenous banks should separate their non-banking business from banking business.
3. They should re-organise their banking business on modern lines. They should maintain proper accounts and get them audited regularly.
4. The wasteful competition between the indigenous bankers and the commercial banks should be ended.
5. The indigenous bankers should stop various malpractices in their business.
6. The benefits of the Banker's Book Evidence Act should be extended to the indigenous bankers also.
7. The indigenous bankers should develop bill-broking business, like bill brokers in the London money market.
8. They should be members of an association.
9. The Reserve Bank should supervise and inspect the conduct of indigenous bankers.
10. The Banking Commission, 1972, in its report suggested that the best way to control the business of indigenous bankers should be through commercial banks. The commercial banks should be encouraged to co-operate with the indigenous bankers.

They should provide help to the indigenous bankers. They should provide facilities to indigenous banks to discount their hundies more easily. Thus, commercial banks must take greater responsibility in controlling the activities of indigenous bankers.

In view of the great role played by the indigenous bankers in the Indian economy, it is better to improve indigenous banking than to abolish it altogether. It is also better to reform them rather than replacing them by commercial banks. Legislation should be passed for regulating the activities of indigenous bankers by the Reserve Bank of India. This will help the Reserve Bank to secure effective control over the Indian money market. In the interest of the development of the country, the indigenous bankers should change their attitude and consider organisational and operational changes. Indigenous banking has a positive and perspective role to play in the money market of India.

2. Moneylenders

Moneylenders are those persons whose primary business is moneylending. They lend money from their own funds. Broadly, the moneylenders may be classified into two categories: (a) the professional moneylenders, and (b) the non-professional moneylenders. Professional moneylenders are those persons whose business is only lending of money. The Maharajas, Sahukars and Banias are professional moneylenders. They usually hold licences for money lending. Non-professional money lenders are those persons who combine moneylending with other activities. They do not depend entirely on moneylending business. They are mainly engaged in other types of activities. They consist of landlords, agriculturists, traders, pensioners, rich windows etc. They have no licence to carry on moneylending business. They give loans to known people within their circle.

Features of Moneylenders

The methods and areas of operations vary from moneylender to moneylender. However, there are certain common features of their activities. They are as follows:

(a) Moneylenders mostly lend their own funds.
(b) The borrowers from moneylenders are mainly illiterate and economically weaker sections of the society.
(c) The loans of the moneylenders are highly exploitative in nature.
(d) The credit provided by moneylenders may be secured or unsecured.
(e) The lending operations of moneylenders are prompt, informal and flexible.

Differences Between Moneylenders and Indigenous Bankers

The following are the important differences between the moneylenders and the indigenous bankers:

1. The primary business of the moneylenders is moneylending. But the primary business of indigenous bankers is not banking.
2. The moneylenders do not accept deposits from the people. But indigenous bankers accept deposits from the people.

3. The indigenous bankers deal in hundies. But moneylenders do not deal in hundies.
4. The indigenous bankers generally lend for trade or productive purposes. But the moneylenders lend for consumption purposes.
5. Moneylenders operate in a limited area. So the scope of their business is limited. But indigenous bankers have a wider area of operation. So they have a large scale financial operations.
6. The indigenous bankers are largely urban-based, where as money-lenders carry on their business in rural areas.
7. Moneylenders functions in an isolated manner. Generally, they do not have any link with the organised sector of the money market. But indigenous bankers maintain some link with the organised sector because of their hundies business.

Defects of Moneylenders

The working of moneylenders has the following defects:

1. The moneylenders have inadequate resources to meet the needs of the rural people.
2. The loans of moneylenders are exploitative in character. They charge very high interest rates. They adopt all types of malpractices in their business. Some of the malpractices are: (a) demanding interest in advance, (b) demanding gifts, (c) manipulating accounts etc.
3. The loans are mostly provided for consumption and unproductive purposes.
4. The moneylenders give loans against standing crops. In this way, they compel the cultivators to sell their produce at low prices to them.
5. Moneylenders have no uniformity in the matter of rate of interest. Different rates of interest are charged in different parts of the country.

The Government has taken various legislative steps to regulate the activities of money-lenders. There are acts like the Deccan Agriculturist Relief Act and the Moneylenders Act passed by the various states in India.

With the growth of rural banks, co-operative societies and other financial agencies in the rural areas, the importance of moneylenders has considerably declined. In near future, they will at the most, play a marginal role in the matter of rural finance in our country.

3. Co-operative Banks

Co-operative banks, another component of the Indian banking organisation, originated in India with the enactment of the Co-operative Credit Societies Act of 1904 which provided for the formation of co-operative credit societies. Under the Act of 1904, a number of cooperative credit societies were started. Owing to the increasing demand of cooperative credit, a new Act was passed in 1912, which provided for the establishment of cooperative central banks by a union of primary credit societies.

Meaning

Co-operative banks is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the co-operative banks collect funds through shares. They accept deposits and grant loans. They are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities.

Structure of Co-operative Banks

Co-operative banking in India is federal in its structure. It has three sections. At the top there is the State Cooperative Bank which is the apex bank at the state level. At the intermediate level there are the central unions or the central cooperative banks. There is generally one central cooperative bank for each district. At the base of the pyramid there are the primary credit societies which cover the small towns and villages. Each higher level institution is a federation of those below, with membership and loan operations restricted to the affiliated units. This structure of cooperative banks is shown in chart 1 and 2.

A. Primary Agricultural Credit Societies

A co-operative credit society, commonly known as the Primary Agricultural Credit Society (PACS) is an association of persons residing in a particular locality. It can be started with ten or more persons. The members generally belong to a village. The membership is open to all the residents of the locality or village. Hence people of different status are brought together into the common organisation.

Each member contributes to the share capital of the society. The value of each share is generally nominal so as to enable even the poorest farmers to become a member. The members have unlimited liability, that is, each member is fully responsible for the entire loss of the society, in the event of failure. This will mean that all the members should know each other fully well. The management is honorary, the only paid member normally being the secretary - treasure. Loans are given for short periods, normally for one harvest season, for carrying on agricultural operations, and the rate of interest is fixed about 6 per cent. Dividends are not declared and profits are generally used for the welfare and improvement of the village. The village co-operative society was expected to attract deposits from among the well-to-do members and non-members of the village and thus promote thrift and self-help. It should give loans and advances to needy members mainly out of these deposits. However, the village societies failed to attract deposits and therefore, the Government had to bring into existence two other credit institutions, known as the Central and State Co-operative Banks, whose main function is to provide funds to the primaries which, in turn, will lend to the farmers.

Chart-1

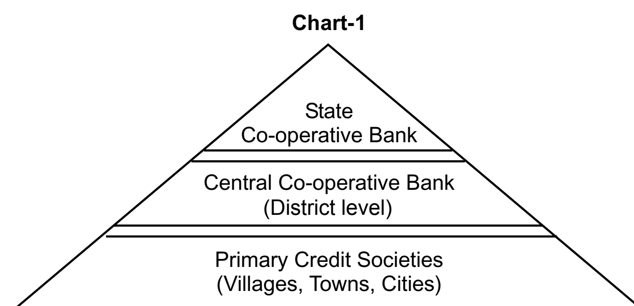


Chart-2

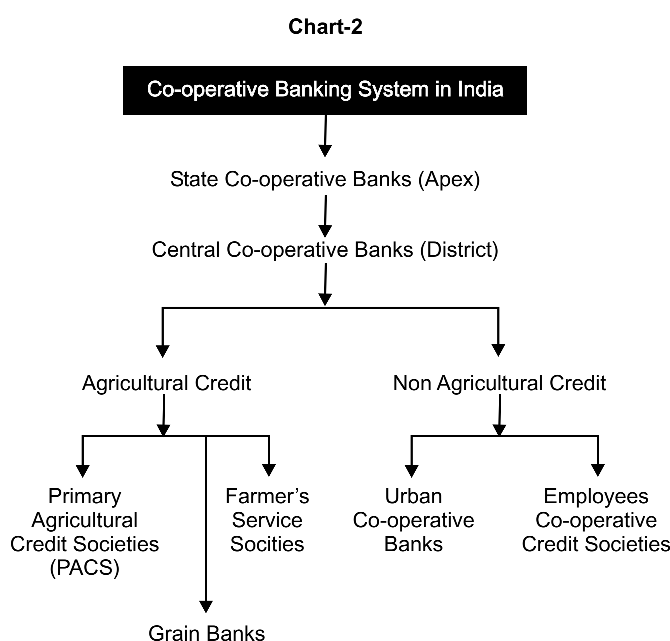


Chart 2: Provides in a nutshell an idea of the co-operative banking system in India.

Progress of PACS

The PACS occupy a strategic position in the co-operative credit structure of the rural economy. In 1951-52, there were 1.08 lakhs PACS. Their number increased to 2.12 lakhs in 1960-61. However, owing to the reorganisation programmes in the various states, their number declined to 94,484 in 1980-81, which further declined to 91,749 in 1985. At the end of June 1986, their number has increased to 92,430. In July 1991, the number declined to 88,000. It increased to 91,000 in 1993-94. Their membership has, however, increased from 6.1 crores in 1981-82 to 7.2 crores in 1985-86. Aggregate deposits of PACS increased from Rs. 314 crores in 1981-82 (July-June) to Rs. 1,349 crores 1990-91 (July-June). Their total loan outstandings have also gone up from Rs. 2,966 crores in 1981-82 to Rs. 4,181 crores in 1990-91. In 1990-91, the total loans overdue of the PACS were to the tune of Rs. 2,784. In 1993-94, the loan overdue amounted to Rs. 3,874 crores.

Shortfalls PACS

Though the PACS have made remarkable progress in the area of rural finance, their shortfalls may be enlisted as under:

1. They have failed to adequately fulfil the credit needs of the small farmers and tenants.
2. A large number of them lacked potential viability.
3. The Banking Commission (1972) observes that PACS neither provided credit for all productive activities of the farmers nor fulfilled their credit needs adequately.

The National Bank for Agriculture and Rural Development (NABARD) has recently stressed the need for a time-bound programme for improving the contents of services rendered by the PACS. It has been suggested that the PACS should: (a) provide diversified credit facilities to their members (b) extend marketing facilities, and (c) mobilise rural deposits.

B. Central Co-operative Banks

The central co-operative banks are federations of primary credit societies in a specific area, normally a district and are usually located in the district headquarters or some prominent town of the district. These banks have a few private individuals as shareholders who provide both finance and management. The central co-operative banks have three sources of fund via, their own share capital and reserves, deposits from the public and loans from the State Co-operative Banks.

The Central Co-operative Banks (CCB) are of two types: (a) pure, and (b) mixed. A pure CCB confines its membership to co-operative organisations only. It is called the Banking Union. A mixed CCB keeps its membership open to co-operatives as well as individuals. Mixed CCBs are found in the states of Assam, Andhra Pradesh, Tamil Nadu, Karnataka and others.

Functions

The major functions of the CCBs are:

1. They finance the primary credit societies. By furnishing credit to the primary socities, CCBs serve as an important link between these societies at the base level and the money market of the country.
2. They accept deposits from the public.
3. They grant credit to their customers on the security of first class gilt edged securities, gold etc.
4. They provide remittance facilities.
5. They act as balancing centres by shifting the excess funds of a surplus primary society to the deficit ones.
6. They keep watch on their debtor primary societies working and progress of recovery of loans.

7. To take up non-credit activities like the supply of seeds, fertilisers and consumer goods necessary to the farmers.
8. To prepare proposals for better utilisation of the financial resources of PACS.

Progress of CCBs

In 1981-82 (July-June) there were 338 central co-operative banks with an aggregate working capital of over Rs. 5,327 crores, or which their total deposits amounted to Rs. 2,768 crores.

In 1993-94 (April-March), their number amounted to 361. Their aggregate working capital has risen to Rs. 27,586 crores, of which deposits amounted to Rs. 16,251 crores.

In 1993-94, CCBs loans outstanding were of the order of Rs. 17,758 crores, of which Rs. 22 per cent was loans overdue.

Defects of CCBs

The following are the major defects of the CCBs:

1. They violate the principle of co-operation by working on the lines of commercial banks.
2. They do not appoint experts to examine the creditworthiness of the primary societies. Hence, there has been problems of recovery and overdues.
3. They combine financing and supervisory work together. As a result supervisory work has been a failure in many cases.
4. Some CCBs have been utilising their reserve funds as working capital. This is not a very sound practice.
5. Mixed CCBs vitiate the very purpose of federation of the primary societies.
6. The CCBs charge very high interest rates to meet their high administration costs of small and uneconomic units.
7. Many CCBs are financially and organisationally weak.

To rehabilitate the weak CCBs, the Government of India formulated a scheme called the Central Sector Plan in 1972. Under the scheme, selected by CCBs were to be provided financial assistance for writing off bad debts. But the operation of the scheme has failed to bring about the desired results for two reasons.

(a) Nobody (including the concerned CCBs) took the programme seriously.
(b) There was no effective functioning of the state and district level committees constituted for monitoring the programme.

C. State Co-operative Banks

The state co-operative banks, also known as apex banks, from the apex of the co-operative credit structure in each state. They obtain their funds mainly from the general public by way of deposits, loans and advance from the Reserve Bank and their own share capital and reserves. Any where between 50-90 per cent of the working capital of the SCBs are contributed by the Reserve Bank. Like the CCBs, SCBs are also pure or mixed.

Functions

The following are the major functions of SCBs:

1. The SCB acts as a banker to CCBs.
2. They have no power to supervise or control the activities of the affiliated CCBs.
3. A SCB serves as a leader of co-operative movement in a state.
4. In the absence of a district co-operative bank in a state, the SCB may give district financial assistance to the primary credit societies.
5. It co-ordinates the policy of the government with the co-operative principles.
6. It also brings about co-ordination between RBI, money market and co-operative credit societies.
7. It gives a number of subsidies to DCBs for improving co-operative credit societies.
8. It simplifies loan distribution system to enable its member to get loans very easily.
9. It helps the government in framing the schemes for the development of co-operatives in the state.

Defects

SCBs also have the same defects of the CCBs. The following are the major defects of SCBs:

1. They mix up commercial banking activities with co-operative banking.
2. They have insufficient share capital.
3. They utilise their reserve funds as working capital.
4. Some SCBs are not pure federations as they permit individual membership along with affiliation to the CCBs.

Progress

During the year 1980-81, there were 27 state co-operative banks, with an aggregate membership of 12,706 CCBs and primary societies and 12,731 individuals. Their aggregate working capital amounted to Rs. 2,749.6 crores.

In June 1991, there were 28 SCBs, the deposits amounted to Rs. 6,128 crores. Their total loans outstanding were of the order of Rs. 9,660 crores. However, their loans overdues account for 18 per cent. In 1993-94 their deposits amounted to Rs. 11,305 crores, and loans outstanding Rs. 9,801 crores.

Present Position of Co-operative Banks

In the real sense, the co-operative movement was from the year 1912, when the defects of the Act 1904 were removed. But the progress has been seen when the Reserve Bank of India has taken keen interest in the growth of the co-operative movement.

The number of Primary (urban) Co-operative Banks (PCBs) at the end of March 1999 stood higher at 1,501 as against 1,431 a year ago (March 1998). The number of licensed

PCBs rose to 1,180 from 1,107 during this period. The number of offices of PCBs moved up to 4,537 from 4,123 at the end of March 1997. Deposits of PCBs aggregated Rs. 23,841 crore at the end of March 1999, rising by 18.6 per cent over the year and their outstanding advances were of the order of Rs. 17,675 crore recording an increase of 19.5 per cent over the year.

Importance or Benefits of Co-operative Banks

The co-operative movement has become a powerful instrument for rapid economic growth. It has resulted in several benefits. The expansion of co-operative banks has resulted in several benefits. They are:

1. They have provided cheap credit to farmers. They discouraged unproductive borrowing.
2. They have reduced the importance of money-lenders. More than 60% of the credit needs of agriculturists are now met by co-operative banks. Thus, co-operative banks have protected the rural population from the clutches of money-lenders.
3. Small and marginal farmers are being assisted to increase their income.
4. They have promoted saving and banking habits among the people, especially the rural people. Instead of hoarding money, the rural people tend to deposit their savings in the co-opertative or commercial banks.
5. They have undertaken several welfare activities. They have also taken steps to improve the morals, polity and education.
6. They have played an important part in changing the old customs and traditions of the people which are an obstacle to progress and economic betterment.
7. They have greatly helped in the introduction of better agricultural methods. Co-operative credit is available for purchasing improved seeds, chemical fertilisers and modern implements cheaply and sell their produce at good prices.

Problems or Weaknesses of Co-operative Banks

Various committees and commissions have reviewed the working of the co-operative banking system. They pointed out a number of weaknesses of the system. Major weaknesses or problems are given below:

1. **Excessive Overdues:** The borrowers from the co-operative banks are not repaying the loans promptly and regularly. There are heavy overdues. Besides overdues at all levels are increasing alarmingly. Lack of will and discipline among the farmers to repay loans is the principal factor responsible for the prevalence of overdues of co-operatives. Large amounts of overdues restrict the recycling of the funds and adversely affect the lending and borrowing capacity of the co-operative societies.
2. **Inefficient Societies:** The co-operative credit societies are managed by people who have no knowledge of co-operation. They do not have necessary experience and training. As a result most of the societies are inefficient.

3. **Regional Disparities:** Co-operative benefits are not evenly distributed as between different states. There is the problem of regional disparities in the distribution of co-operative credit. The loans advanced per member varies widely. The farmers of Gujarat, Punjab, Haryana and Tamil Nadu are getting much more than those in Orissa, Bihar and West Bengal. Besides, the production loans and investment credit supplied in most of the tribal and hill areas is comparatively very less.
4. **Benefits to Big Land Owners:** Most of the benefits from co-operative have been cornered by the big land owners because of their strong socio-economic position. Small farmers are neglected by co-operative societies. Poor farmers are not able to get enough credit.
5. **Dependence on Outside Resources:** Co-operative societies or banks depend heavily on outside resources. State Governments and NABARD are the main sources of funds to co-operative societies. This heavy dependence on outside resources will be a great problem in future.
6. **Political Interference:** The co-operative societies are dominated by political parties and politicians. There is favouritism and nepotism in the granting of loans.
7. **Inadequate Coverage:** Co-operatives have now covered almost all the rural areas of the country. But the membership is only around 45 % of the rural families. 55 % of rural families are thus still not covered under the co-operative credit system. Agricultural labourers and rural artisans constituted only 10 % of the total membership of the co-operative credit system. The weaker sections of the rural community are still not adequately represented in the membership roll.
8. **Lack of Other Facilities:** Besides the provision of adequate and timely credit the small and marginal farmers also need other facilities in the form of supply of better seeds, fertilisers, pesticides etc. and marketing services. Very little attention is paid on the provision of such facilities.
9. **Dual Control:** There is dual control of the co-operatives, on the one side the NABARD and on the other by the State Government under the Co-operative Societies Act. Co-operative societies are treated as part and parcel of the Government has discouraged initiative in management.
10. **Competition from Private Agencies:** Co-operative banks are facing stiff competition from money-lenders and traders. Because of this competition, co-operatives could not make much progress.
11. **Credit Linked to Assets:** The credit given to a member is based on his assets. Those who do not have assets or those who have small assets do not get enough credit.

Suggestions for the Improvement of the Co-operative Credit Structure

1. The resources of the co-operative banks should be improved. Their dependance on outside resources must be reduced considerably.

2. The primary societies should be made more viable and economically strong units.
3. The liability of the members of the primary co-operatives should be made limited.
4. Loans should be given not on the basis of the assets of the member but on the basis of the estimated value of production. Although this method is introduced, it is not functioning properly, and not all societies have implemented it.
5. Loans given should be enough to meet agricultural and other expenses so that the members need not approach the money-lenders.
6. Agricultural inputs like fertilisers, seeds etc., should be supplied by the co-operatives. Credit and marketing should be integrated. Marketing and processing activities should be undertaken by the co-operatives.
7. The co-operatives should be given freedom to adopt management practices, rules and regulations to suit the local needs and conditions.
8. Co-operative training facilities should be expanded and the co-operatives should be manned by well trained personnel. Management should be professionalised.
9. Co-operative movement should become people's movement. They should be made to realise the benefits of co-operations.
10. They should be made agents of commercial banks wherever possible.
11. Steps must be taken for effective audit and inspection.
12. Political interference in the affairs of the co-operatives must be put to an end.
13. Co-operative should take steps to commercialise agriculture to increase the income level to the members and introduce appropriate technologies in agriculture. Members should be encouraged to take up subsidiary occupations.

    Co-operative banks should diversify their activities and take up banking related services just like commercial banks. The credit societies or banks should be reorganised into multi-purpose societies.

4. Land Development Bank

Already, co-operative credit institutions were started and were working successfully in providing short-period credit to farmers. The Government wanted a special credit institution which would cater to the long-term credit needs of the farmers. Such an institution should be able to assist farmers with long-term loans carrying modest rates of interest and convenient methods of repayment. The Government started the land mortgage banks for this purpose; these banks have now come to be called the land development banks.

The land development banks were setup during the 1920's but their progress has been quite slow. After independence, they have been enjoying a great measure of prosperity, but whatever progress has been achieved is concentrated in only a few states viz., Tamil Nadu, Andhra Pradesh, Karnataka, Maharashtra and Gujarat. There are two types of land development banks in the country. At state level, there are Central Land Development Banks, and under each central bank, there are primary land development banks. In some states, there is one Central Land Development Bank for the state which has branches all over the state.

Sources of Funds

There are three important sources of funds of land development banks: (a) their own share capital and accumulated reserves (b) deposits from the general public, and (c) issue of bonds or debentures. The first two sources did not assume any significance and land development banks largely depend upon the third source. They are issued by the Central Land Development Banks and they carry a fixed rate of interest. The period of the debentures varies from 20-25 years. The banks issue two types of debentures, namely ordinary and rural debentures. The period of rural debentures varies between 7 and 15 years. The banks are required to create regular sinking funds to provide for repayment of the debentures. The debentures are generally guaranteed by the State Governments regarding payment of interest and repayment of principal. They are subscribed for by the public, the cooperative banks, commercial banks, the State Bank of India, the LIC and the Reserve Bank of India. These debentures are classified as trustee securities. The Reserve Bank lends on the security of these debentures, if they are guaranteed by the concerned state Government.

The Working of the LDBs

The Land Development Banks provide long-term loans to the agriculturists for permanent improvements on land. They usually charge a percent interest. They grant loans against the security of land or other agricultural property. Loans are usually given on the first mortgage and sometimes even on the second mortgage of land or agricultural property. Generally, they give loans up to 50 per cent of the market value of the mortgaged property.

Progress

A remarkable progress has been made by the LDBs in providing long-term finance to the agriculturists. The total number of LDBs (central and primary) increased from 481 in 1960-61 to 920 in 1984-85. In 1984-85 their number of membership had gone up to 10.6 lakhs. In 1984-85, their loan outstanding were to the tune of Rs. 3,643 crores and loan overdues amounted to Rs. 409 crores.

Defects

Several defects have been noticed on the operational side of the Land Development Banks.

1. They charge very high rates of interest.
2. On account of red-tapism, there are the usual delays up to more than a year in granting loans.
3. No second loan is given until the first one is repaid.
4. They give loans only up to 50 per cent of the value of the land mortgaged. Thus, a very high margin is kept.
5. They adopt complicated procedures which ultimately force the illiterate farmers to resort to money-lenders to meet their financial requirements.
6. Quite often, loans are granted to discharge prior debts rather than for land improvement.

Suggestions for Improvement

The Reserve Bank of India has made many practical suggestions to tone up the working of the land development banks. First of all, land development banks should not be of the same uniform type as was the case in the past. India, being a large country, exhibits diversity of local conditions. Hence land development banks should reflect these diversities. Secondly, primary land development banks should be set up in large numbers–one for a small group of villages. The purpose is that they are located as near the farmers as possible so as to induce the latter to approach the development bank easily. Thirdly, the land development banks should charge low rates of interest–may be 4 per cent or so–to enable the small and marginal farmers to approach them for assistance. Finally, these banks should make efforts to improve their efficiency and work along with other agencies which are also providing credit for farmers.

5. Regional Rural Banks

In spite of the rapid expansion programmes undertaken by the commercial banks in recent years, a large segment of the rural economy was still beyond the reach of the organised commercial banks. To fill this gap it was thought necessary to create a new agency which could combine the advantages of having adequate resources but operating relatively with a lower cost at the village level.

After the declaration of emergency, the then Prime Minister, Smt. Indira Gandhi, announced on July 1, 1975 the 20 point economic programme of the Government of India. One of the points of this programme was the liquidation of rural indebtedness by stages and provide institutional credit to farmers and artisans in rural areas. The Government of India promulgated on September 26, 1975, the Regional Rural Bank Ordinance, to set up regional rural banks throughout the country; the Ordinance was replaced by the Regional Rural Banks Act, 1976. The main objective of the regional rural banks is to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in rural areas.

Objectives of Regional Rural Banks

The following are the main objectives of regional rural banks:

1. To provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans, small entrepreneurs and other weaker sections.
2. To develop agriculture, trade, commerce, industry and other productive activities in the rural areas.
3. To provide easy, cheap and sufficient credit to the rural poor and backward classes and save them from the clutches of money lenders.
4. To encourage entrepreneurship.
5. To increase employment opportunities.
6. To reconcile rural business aims and social responsibilities.

Capital Structure

At present, the authorised capital of regional rural banks is Rs. 5 crores, and the issued capital is Rs. 1 crore 50% of the issued capital is to be subscribed by the Central Government, 15% by the concerned State Government, and 35% by the sponsoring commercial banks. The shares of regional rural banks are to be treated as "approved securities."

Features of Regional Rural Banks

The following are the features of the regional rural banks:

1. The regional rural bank, like a commercial bank, is a scheduled bank.
2. The RRB is a sponsored bank. It is sponsored by a scheduled commercial bank.
3. It is deemed to be co-operative society for the purposes of Income Tax Act, 1961.
4. The area of operations of the RRB is limited to a specified region relating to one or more districts in the concerned state.
5. The RRB charges interest rates as adopted by the co-operative societies in the state.
6. The interest paid by the RRB on its term deposits may be 1% or 2% more than that is paid by the commercial banks.
7. The regional rural bank enjoys many concessions and privileges.

Functions of Regional Rural Banks

The functions of Regional Rural Bank are as follows:

1. Granting of loans and advances to small and marginal farmers and agricultural labourers, either individually or in groups.
2. Granting of loans and advances to co-operative societies, agricultural processing societies and co-operative farming societies primarily for agricultural purposes or for agricultural operations and other related purposes.
3. Granting of loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade, commerce and industry or other productive activities within a specified region.
4. Accepting various types of deposits.

The credit policy of regional rural banks is more liberal than co-operative banks. It is not necessary for the borrower to mortgage property or deposit title deeds. It is not necessary to produce "not encumbrance certificate" or get legal opinion.

Progress Achieved by Regional Rural Banks

The Regional Rural Banks have achieved significant progress in all directions. The progress achieved is discussed below:

1. **Number of Banks:** The first, five regional rural banks were started at Moradabad and Gorakhpur in Uttar Pradesh, Bhiwani in Haryana, Jaipur in Rajasthan and Malda in West Bengal. There are now (June 2001) 196 regional rural banks, covering

over 400 districts in the country with 14,550 branches. The largest number of offices are started in Uttar Pradesh.

2. **Deposits:** The deposits of regional rural banks increased substantially over the years. The total deposits were only Rs. 20 lakhs in 1975. They increased to Rs. 25, 430 crores by June 2001.
3. **Advances:** Total advances granted by all regional banks amounted to Rs. 10 lakhs in 1975. The total advances granted increased to Rs. 11,020 crores in 2000. Over 90 % of the advances of regional rural banks are direct advances to small and marginal farmer, landless labourers and rural artisans.
4. **Self-employment Schemes:** The regional rural banks are making notable effort to encourage self-employment schemes.
5. **Creation of Local Employment Opportunities:** Regional rural banks have been taking active steps to create employment for the local people and achieved good success.
6. **Participation in Various Programmes:** During the last 22 years regional rural banks have been active participants in programmes designed to provide credit assistance to weaker sections. For instance, they are providing credit assistance to identified beneficiaries under the New 20-Point Programme for scheduled castes and tribes.
7. **Assistance to Physically Handicapped Persons:** Physically handicapped persons are provided finance for purchase of artificial limbs, hearing aids, wheel chairs etc.
8. **Farmers Societies:** Regional rural banks have also sponsored and financed about 90 farmers societies.
9. **Integrated Rural Development Programme (IRDP Scheme):** Regional rural banks have been taking active part in the Integrated Rural Development Programme.

Regional rural banks, thus, have achieved notable progress in expanding branch network and extending credit support to weaker sections in rural areas. They exist as rural banks of the rural people.

Problems

The following are the major problems faced by the regional rural banks:

1. **Existence of Overdues:** The most serious problem faced by the regional rural banks is the existence of heavy overdues. Overdues are rising continuously. It is estimated that about 30 % of the loans sanctioned still remain due from the borrowers. This has caused innumerable financial problems besides limiting the capacity of regional rural banks to lend and operated as viable units.
2. **Losses:** Most of the regional rural banks are not economically viable. They have been continuously incurring losses for years together. The accumulated losses are estimated to be Rs. 1200 crores upto March 2000.

3. **Limited Channels of Investment:** Since the regional rural banks have to lend to small and marginal farmers and other weaker sections of the society, the channels of investment are limited. Therefore, their earning capacity is low.
4. **Difficulties in Deposit Mobilisation:** Regional rural banks have been facing a number of practical difficulties in deposit mobilisation. Richer sections of the village society show least interest in depositing their money in these banks because they are served by these banks.
5. **Procedural Rigidities:** Regional rural banks follow the procedures of the commercial banks in the matter of deposits and advancing loans. Such procedures are highly complicated and time-consuming from the villagers point of view.
6. **Hasty Branch Expansion:** There is haste and lack of coordination in branch expansion. It has resulted in lopsidedness in branch expansion. It has increased infrastructure costs and reduced profitability.
7. **High Establishment Costs:** The salary structure of regional rural banks has been revised with the result that establishment costs have gone up. The regional rural banks are unable to cover the increased costs, since their customers are specified weaker sections enjoying concessional interest on loans and advances. The surplus available for meeting interest on deposits, administration costs and other expenses is said to be very low.
8. **Multi-agency System of Control:** Regional rural banks are controlled by many agencies. The present multi-agency control of regional rural banks involves sponsor banks, NABARD, Reserve Bank, State Governments and the central government. This is not conducive to high operational efficiency and viability. So the present multi-agency system of control should be replaced by single agency control.
9. **Slow Progress in Lending Activity:** The growth in loan business of regional rural banks is low. For this the following reasons may be given:
   (a) There has been limited scope for direct lending by regional rural banks in their fields of operation.
   (b) It is always difficult to identify the potential small borrowers.
   (c) Most of the small borrowers do not like the bank formalities and prefer to borrow from the money-lenders.
   (d) There is lack of co-ordination between officials of district credit planning committees and the regional rural banks.
10. **Inefficient Staff:** As the salary structure of regional rural banks is not attractive when compared to other banks, efficient persons have a tendency to shift to commercial banks to improve their salary and career. Besides, many employees are not willing to work in villages. There is no true local involvement of the bank staff in the villages they serve.

    Despite these problems, the regional rural banks have been trying their level best to achieve their social objectives. They have succeeded in projecting their image of

"Small Man's Bank." They are in fact, development banks of the rural poor. They have been trying to fill regional and functional gaps in rural finance in our country.

Suggestions for Reorganisation and Improvement

Several expert groups have made a number of suggestions necessary to reorganise the structure and improve the working of regional rural banks. The important suggestions are given below:

1. These banks should continue to work as rural banks of the rural poor.
2. The state governments should also take keen interest in the growth of Regional Rural Banks.
3. Participation of local people in the equity share capital of the regional rural banks should be allowed and encouraged.
4. The regional rural banks should be linked with primary Agricultural co-operative societies and Farmer's service societies.
5. The regional rural banks should be strongly linked with the sponsoring commercial banks and the Reserve Bank of India.
6. A uniform pattern of interest rate structure should be devised for the rural financial agencies.
7. The regional rural banks must strengthen effective credit administration by way of credit appraisal, monitoring the progress of loans and their efficient recovery.
8. The regional rural banks should increase their consumption loans to the villagers and weaker sections. They should be allowed to increase their loans to richer sections of the society.
9. The regional rural banks should be permitted to provide full range of banking services, such as, remittance and other agency services, which would help a lot in developing banking habits among the villagers.
10. The regional rural banks should diversify their loans.
11. The present multi-agency system of control of regional rural banks should be replaced by single agency control.
12. As far as possible, natives should be appointed to work in them. The employees should be given suitable training.
13. Effective steps should be taken to prevent the misuse of funds by borrowers and willful defaulters.
14. Lending procedures should be made easy in order to avoid undue delays.
15. The image of regional rural banks should be improved. They should not be identified as "Second class" banks or an extension of the urban-oriented commercial banks. They must develop their own identity.

Regional rural banks have an important role to play in our rural economy as they have to act as alternative agencies to provide institutional credit in rural areas. They have not been set up to replace co-operative credit societies but supplement them. What the commercial

banks have not done in rural areas, regional rural banks are trying to do it now. A such, regional rural banks should be specially assisted to solve their problems and be made real promoters of growth in rural India.

6. NABARD

The National Bank for Agriculture and Rural Development (NABARD) was set-up on 12th July, 1928 under an Act of Parliament. It has been established by merging the Agricultural Credit Department, and Rural Planning and Credit Cell of the Reserve Bank and the entire undertaking of Agricultural Refinance and Development Corporation. Hence, the National Bank has to perform a dual function: (a) The function of the Reserve Bank as an apex institution, and (b) The function of Agricultural Refinance and Development Corporation as a refinance institution.

Objectives

The National Bank for Agricultural and Rural Development (NABARD) is essentially a development bank for promoting agricultural and rural development. The major objectives of NABARD are:

1. To give financial assistance for increasing the agricultural production.
2. To supply the long-term needs of the rural areas.
3. To supply loans by way of refinance.
4. To help small industries, cottage industries and also artisans.
5. To achieve overall rural development.

NABARD's Financial Resources

The authorised capital of NABARD is Rs. 500 crores and the paid up capital is Rs. 100 crores. The paid-up capital is contributed by the Central Government and the Reserve Bank in equal proportions. At the time of its establishment, loans and advances granted by the Reserve Bank and outstanding against state co-operative banks and regional rural banks were transferred to NABARD. Besides, the Reserve Bank has also sanctioned a credit of Rs. 1200 crores to NABARD. Credits are also received from the U.K., the U.S.A., the Netherlands, Switzerland and West Germany. Besides these, NABARD has been raising funds from the market through the issue of debentures. To meet the loan requirements NABARD draws funds from the Government of India, the World Bank and other agencies. NABARD had raised resources to the extent of Rs. 11,000 crores between 1983 and 1999. NABARD has thus sufficient financial resources for financing all agricultural and rural development programmes. At present its paid up capital is Rs. 2000 crores.

Management

NABARD is managed by a Board of Directors, consisting of a Chairman, a Managing Director and 13 other Directors. They are appointed by the Central Government in consultation with the Reserve Bank. There will be also an Advisory Council.

Functions of NABARD

NABARD does not provide credit directly to the farmers and other rural people. It provides refinance credit to the state co-operative banks, regional rural banks and other financial institutions as may be approved by the Reserve Bank. It is a single integrated agency for meeting the credit needs of all types of agricultural and rural development activities. It performs the following functions:

1. **Apex Institution for Rural Finance:** NABARD performs all the functions which were previously performed by the Reserve Bank of India. It directs the policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas. It, thus acts as an apex bank in the country for supporting and promoting agriculture and rural development. It is described as "Rural Reserve Banks."
2. **Refinance Institution:** It serves as an apex refinancing agency for the institutions providing production and investment credit for promoting various developmental activities in rural areas. These activities are related to agriculture, small scale industries, village and cottage industries, handicrafts, small artisans etc. NABARD has taken over the function of refinancing from the Agricultural Refinance Development Corporation. It provides refinance facilities to state co-operative banks, regional rural banks, commercial banks and other financial institutions approved by the Reserve Bank of India. Commercial banks lead in availing of refinance from NABARD.
3. **Credit Functions:** NABARD is empowered to give short-term, medium-term and long-term loans in a composite form. It looks after the credit requirements of all types of agricultural and rural development activities.
   (a) It provides short-term, medium-term and long-term credits to state co-operative banks, land development banks, regional rural banks and other financial institutions approved by the Reserve Bank of India.
   (b) It grants long-term loans, upto 20 years, to state governments to enable them to subscribe to the share capital of co-operative credit societies.
   (c) It provides medium-term loans to state co-operative banks and regional rural banks for agricultural and rural development.
   (d) It gives long-term loans to any institution approved by the Central Government.
4. **Contribution of Share Capital:** NABARD contributes to the share capital of any institution concerned with agriculture and rural development.
5. **Investment in Securities:** NABARD can invest in securities of any institution concerned with agriculture and rural development. For promoting innovative investments, NABARD has started "Venture capital fund."
6. **Conversion and Rescheduling Facilities:** NABARD provides refinance to eligible institutions for conversion and rescheduling of loans, under conditions of drought, famine or other natural calamities, military operations etc.

7. **Financial help to Non-agricultural Sector:** Besides providing credit to agricultural and allied activities, the NABARD also renders financial help to the non-agricultural sector with the aim of promoting integrated rural development. It provides financial assistance to small scale industries, cottage and village industries and industrial co-operative societies for meeting their working capital and fixed capital needs.
8. **Co-ordination of Activities:** NABARD co-ordinates the activities of central and state governments, planning commission and other institutions concerned with the development of small-scale industries, village and cottage industries, rural crafts and industries in the decentralised sector.
9. **Regulatory Function:** NABARD has the responsibility to inspect regional rural banks, and central and state co-operative banks.
10. **Maintenance of Research and Development Fund:** NABARD maintains research and development fund: (a) to promote research in agriculture and rural development, (b) to formulate programmes to suit the requirements of different areas, and to cover special activities.
11. **Training Programmes:** NABARD has to provide comprehensive training programmes to its own staff as well as to the staff of state co-operative banks, regional rural banks etc. The training is to be meant for upgrading the technical skill and competence of the staff.
12. **Evaluation of Projects:** NABARD undertakes monitoring and evaluation of projects refinanced by it. It is responsible for the development, policy, planning operational matters, co-ordination, monitoring, training, consultancy etc., relating to rural credit:

Achievements of NABARD

NABARD is playing a vital role in the reduction of regional imbalances and providing assistance to small farmers, marginal farmers and weaker sections. It has been performing its various functions smoothly. Its performance in extending various types of financial assistance is as follows:

1. **Short-term Assistance:** NABARD sanctioned short-term credit limits worth Rs. 6230 crores during 1997-98 to state co-operative banks for financing seasonal agricultural operations. The credit facility is available at a concessional rate of 3% below the bank rate.
2. **Medium-term Assistance:** NABARD has continued to follow the policy earlier laid down by the Reserve Bank in regard to sanctioning medium-term credit limits for approved agricultural purposes. A major portion of medium-term credit of NABARD went to state co-operative banks and central co-operative banks to convert short-term loans granted to farmers into medium-term loans.
3. **Long-term Assistance:** NABARD grants long-term credit to State Governments for contribution to the share capital of co-operative institutions. During 1997-98, it extended long-term credit worth Rs. 210 crores.

4. **Schematic Lending:** During 1997-98 NABARD sanctioned 6,810 schemes involving its own commitments of Rs. 3930 crores. Largest number of schemes sanctioned were related to minor irrigation followed by those related to farm mechanisation. Land development, farm mechanisation, plantations and horticulture, poultry, sheep-breeding, piggery, dairy, fisheries etc., are other important schemes which are financed by NABARD.
5. **Assistance to Less Developed States:** NABARD like ARDC has continued the policy of promoting agricultural investment in the less developed and unbanked states. Uttar Pradesh, Bihar, Madhya Pradesh, Rajasthan and Orissa have been receiving the largest share of financial benefits from NABARD.
6. **Assistance to Non-farm Sector:** NABARD has also provided financial help to non-farm activities with a view to promote integrated rural development. Finance has been provided for production and marketing activities of co-operative sugar mills, handloom weaver's societies, industrial co-operatives, rural artisans etc.
7. **Rehabilitation Programme:** NABARD has been playing an energetic role in strengthening and reorganising the co-operative structure in the country. It has initiated a rehabilitation programme for financially and administratively weak central and state co-operative banks. It has also been providing help in the rehabilitation work of state land development banks and primary land development banks. State Governments have been asked to take effective steps to ensure functional co-ordination between short-term and long-term credit by co-operatives. It has also created a "cell" to monitor the implementation of this directive.
8. **Assistance to Research and Development Projects:** Every year NABARD has been providing financial help to a number of banks from its Research and Development Fund for setting up or strengthening their "Technical Monitoring and Evaluation Cell." It has been sanctioning funds for organising research, conferences and seminars on subject having relevance to NABARD.
9. **Credit Plans Under the New Strategy:** Under the "Service Area Approach", the annual credit plans are prepared by the bank branches. The district level offices of the NABARD would help to improve the quality of credit plans prepared by banks branches and also co-ordinate and effectively monitor the credit plans.
10. **Integrated Rural Development Programme:** NABARD has helped the implementation of the "Integrated Rural Development Programme." Under the 20-point Economic Programme, the NABARD has taken steps to provide adequate financial facilities to the weaker sections of the society.
11. **Regional Rural Banks:** After the establishment of NABARD, all the refinance facilities earlier available to regional banks have been provided by NABARD.

Thus, NABARD has given a tremendous push to agricultural credit and thus promoted agricultural and rural development. Today, the NABARD has become a king-pin of rural development.

7. Commercial Banks

Commercial banks are very popular almost in every country because of the service they provide to individuals, commerce and industry. A commercial bank may be defined as a financial institution which accepts deposits against which cheques can be drawn, lends money to commerce and industry and renders a number of other useful services to the customers and the society. Commercial banks borrow money from those who have surplus funds and lend to those who need funds for commercial and industrial purposes. Thus, they act as dealers in loanable funds of the society. Commercial banks receive deposits in the form of fixed deposits, savings bank accounts and current accounts and advance money, generally for short periods, in the form of cash credits, overdrafts and loans. They also render a number of service to their customers, such as collection of cheques, safe custody of valuables, remittance facilities and payment of insurance premium, electricity bills, etc.

The commercial banks perform the following major functions:

(a) Receiving deposits from the public and the business firms.
(b) Lending money to various sections of the economy for productive activities.
(c) Issue of demand drafts, traveller's cheques, bank cards, etc., for the smooth remittance of funds.
(d) Provision of locker facility to the customers.
(e) Safe custody of documents, ornaments and other valuables of customers.
(f) Payment of telephone, electricity and water bills on behalf of the customers.
(g) Collection of cheques of the customers.
(h) Issue of letters of credit.
(i) Acting as trustees, executors of wills, etc.

Nationalisation of Banks

The Government of India nationalised 14 major banks in the country in July 1969 and another 6 banks in 1980. The nationalisation of banks was described as "historic", "momentous," "bold" and "timely" by certain sections of the people. The State Bank of India and its seven subsidiaries had already been nationalised. The regional rural banks from their very inception are in the public sector. Thus about 90% of the country's commercial banking system is now in the public sector.

Achievements of Nationalised Banks

A banking revolution occurred in the country during the post-nationalisation era. There has been a great change in the thinking and outlook of commercial banks after nationalisation. There has been a fundamental change in the lending policies of the nationalised banks. Indian banking has become development-oriented. It has changed from class banking to mass-banking or social banking. This system has improved and progressed appreciably. Various achievements of banks in the post-nationalisation period are explained below.

1. **Development-oriented Banking:** Historically, Indian banks were mainly concerned with the growth of commerce and some of the traditional industries such as, cotton textile and jute. The banks were concentrated in the big commercial centres. They mostly granted short-term commercial loans. They were unwilling to venture into new fields of financing. But after nationalisation of banks, the concept of banking has widened from acceptance of deposits and mere lending to development oriented banking. Banks are increasingly catering to the needs of industrial and agricultural sectors. From short-term lending, banks have been gradually shifting to medium and even long-term lending. From well-established large industries and business houses, banks are positively shifting to assisting small and weak industrial units, small farmers, artisans and other neglected groups of people in the country. They have adopted the Lead Bank Scheme. Under this scheme, all the districts of the country are allotted to some bank or the other. The lead bank of district is actively engaged in:
   (a) Opening bank branches in all important localities.
   (b) Providing maximum credit facilities for development in the district, and
   (c) Mobilising the savings of the people in the district.

2. **Branch Expansion:** Rapid economic development pre-supposes rapid expansion of commercial banks. Initially, the banks were conservative and opened branches mainly in cities and big towns. Branch expansion gained momentum after nationalisation of top commercial banks and the introduction of "Lead Bank Scheme." The Lead Bank Scheme has played an important role in the bank expansion programme. The number of branches of all scheduled commercial banks increased from 8,260 in 1969 to 64,240 in 1998. Thus within 38 years after bank nationalisation, there was over 800 per cent increase in the number of branches. There had been a significant increase in bank branches in the rural, underbanked and unbanked areas. The number of branches in rural areas increased from 1860 in 1969 to 32,880 in 1998. With the progress of branch expansion programme, the national average of population per bank office has declined from 63,800 to 15,000. M. Gopalkrishnan says "the single striking feature of the post-nationalisation banking scene is the rapidity with which the branch network has multiplied itself. The rate of branch expansion has been unparalleled any where else in the world." Thus, the overall growth of bank branches in the last 30 years has been remarkable in its geographical coverage and removal of regional imbalances in the country.
3. **Expansion of Bank Deposits:** Since nationalisation of banks, there has been a substantial growth in the deposits of commercial banks. Bank deposits had increased from over Rs. 5,910 crores in 1970-71 to over Rs. 8,10,070 crores in 1999-2000. Thus bank deposits had increased by 150 times. Development of banking habit among people through publicity, extensive branch banking and prompt service to the customers led to increase in bank deposits. To attract deposits, Indian banks have introduced many attractive saving schemes. To attract deposits from widely scattered areas, mobile bank's branches have been introduced by a number of banks.

A number of banks have started evening branches, Sunday branches for the benefit of their customers. Apart from the quantitative increases in deposits, there has been an impressive qualitative shift. The number of small account holders with the banks has been increasing day-by-day. Aggregate deposits are composed to time deposits and demand deposits. Earlier there was predominance of demand deposits. Now there is predominance of time deposits. The ratio of time deposits to total deposits has been increasing.

4. **Credit Expansion:** The expansion of bank credit has also been more spectacular in the post-bank nationalisation period. Bank credits had increased from Rs. 4,700 crores in 1970-71 to Rs. 4,43,180 crores in 1999-2000. At present, banks are also meeting the credit requirements of industry, trade and agriculture on a much larger scale than before. Credit is the pillar of development. Bank credit has its crucial importance in the context of development and growth with social justice.
5. **Investment in Government Securities:** The nationalised banks are expected to provide finance for economic plans of the country through the purchase of government securities. There has been a significant increase in the investment of the banks in government and other approved securities in recent years. The investments increased from Rs. 1,727 crores in 1970 to 74,370 crores in 1995.
6. **Advances to Priority Sectors:** An important change after the nationalisation of banks is the expansion of advances to the priority sectors. One of the main objectives of nationalisation of banks to extend credit facilities to the borrowers in the so far neglected sectors of the economy. To achieve this, the banks formulated various schemes to provide credit to the small borrowers in the priority sectors, like agriculture, small-scale industry, road and water transport, retail trade and small business. The total credit provided by banks to the priority sectors has increased from Rs. 440 crores in 1969 to Rs. 91,300 crores in March 1998. As a result, advances to priority sectors as percentage of total credit increased from 15% in 1969 to 42% in 1998. The bank lending to priority sector was, however, not uniform in all states. It was quite low in many backward states like U.P., Bihar and Rajasthan. Under the new banking policy stress is laid on the weaker and under-privileged groups in the priority sector "weaker sections" refer to all persons who became suppressed, depressed and oppressed because of socio-political, socio-economic or socio-religious reasons. The concept of profitability has been substituted by "social purposes" with regard to lending to weaker sections of the society. Quantitatively, banks have done well in priority lending. But overdues and bad debts have been a serious problem faced by banks in respect of advances made to the weaker sections of the society. There is always the problem of ensuring the effective end use of the loans given to the priority sectors.
7. **Social Banking -Poverty Alleviation Programmes:** Commercial banks, especially the nationalised banks have been participating in the poverty alleviation programme launched by the government.

(a) *Differential Interest Scheme:* With a view to provide bank credit to the weaker sections of the society at a concessional rate the government introduced the "Differential interest rates scheme" from April 1972. Under this scheme, the public sector banks have been providing loans at 4 % rate of interest to the weaker sections of the society. The scheme has shown notable progress. The number of accounts was 2 million and the advances outstanding were Rs. 640 crores at the end of March 1996.

(b) *Integrated Rural Development Programme (IRDP):* This is a pioneering and ambitious programme to rectify imbalances in rural economy and also for all-round progress and prosperity of the rural masses. Under this programme banks has assisted nearly 1.8 million beneficiaries during 1997-98 and disbursed a total amount of Rs. 1990 crores as loan. Out of the beneficiaries, over 1 million belonged to scheduled castes and scheduled tribes and 0.7 million were women.

Other important scheme introduced by the government of India and implemented through the banking system includes (a) self-employment scheme for educated youth, (b) self-employment programme for urban poor, and (c) credit to minority communities.

8. **Growing Importance of Small Customers:** The importance of small customers to banks has been growing. Most of the deposits in recent years have come from people with small income. Similarly, commercial banks lending to small customers has assumed greater importance. Thus banking system in India has turned from class-banking to mass-banking.
9. **Innovative Banking:** In recent years, commercial banks in India have been adopting the strategy of "innovative banking in their business operations." Innovative banking implies the application of new techniques, new methods and novel schemes in the areas of deposit mobilisation, deployment or credit and bank management. Mechanisation and computerisation processes are being introduced in the day-to-day working of the banks.
10. **Diversification in Banking:** The changes which have been taking place in India since 1969 have necessitated banking companies to give up their conservative and traditional system of banking and take to new and progressive functions. The government had been encouraging commercial banks to diversiy their functions. As a result, commercial banks have set up merchant banking divisions and are underwriting new issues, especially preference shares and debentures. There are now eight commercial banks which have set up mutual funds also. Commercial banks have started lending directly or indirectly for housing. Venture capital fund is also started by one public sector bank. State Bank of India and Canara Bank have set-up subsidiaries exclusively for undertaking "factoring services." In future all commercial banks can be expected to diversify their functions and adopt new technologies.
11. **Globalisation:** The liberalisation of the economy, inflow of considerable foreign investments, frequency in exports etc., have introduced an element of globalisation in the Indian banking system.

8. Credit Cards

Now-a-days some banks are issuing credit cards. The system of issuing credit cards originated in the U.S.A. Credit cards have become very popular in the U.S.A. Credit cards are issued in the name of companies to be used by designated executives. They are also issued in the name of individuals to be charged to the company's account or to the personal account.

The credit card system is utilised by big companies, super rich and highly paid executives in our country. But credit cards are not accepted by all establishments in the country. In our country only luxury hotels, airlines, shops and other establishments dealing in costly and luxury goods or providing costly services accept credit cards provided, they have arrangements with the issuing bank.

Advantages of Credit Cards

Credit card holders enjoy certain privileges and advantages. They are:

1. Credit cards enable persons to purchase goods and services on credit in establishments which accept them. They enjoy credit facility without paying interest for above four to six weeks.
2. Carrying a credit card is more convenient and safer than carrying cash or cheque book.
3. The credit card gives the traveller peace of mind as it takes care of all his needs.
4. Credit card is a safer and convenient method of payment.
5. A credit card holder will be recognised as a man of sound financial standing.
6. The issuing bank or concern will debit the credit card holder or customer's account once in month after receiving details about purchases.

Limitations or Drawbacks of Credit Cards

The following are the limitations or disadvantages:

1. Credit cards cannot be used for making purchases in all business establishments.
2. Issuing bank will place a limit on the expenditure by the credit card holder.
3. Credit card system will increase indebtedness among the card holders. For example, indebtedness has increased tremendously on account of the credit card system in the U.S.A.

Inspite of the limitations, credit cards have become popular instrument in recent years in most of the countries in the world. The future commerce is e-commerce. Credit cards facilitate e-commerce.

Conclusion

It is thus clear that in India, there are different kinds of banks, viz., indigenous bankers, money-lenders, co-operative banks, NABARD, land development banks, regional rural banks, commercial banks including the State Bank of India and its subsidiaries and foreign exchange banks. Overall these institutions, there is the Reserve Bank of India which is the central bank of the country.

Questions for Discussion

1. Give an account of the role and significance of indigenous banking.
2. Examine the role of the money-lenders in the provision of agricultural finance.
3. What were the objectives of the nationalisation of the major commercial banks in India? How far have these objectives been achieved so far?
4. Describe the structure of the co-operative bank in India and explain the function of co-operative banks.
5. Evaluate the progress and problems of Land Development Banks.
6. NABARD is described as "Rural Reserve Bank," explain.
7. Critically examine the objectives and achievements of regional rural banks in India.

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7

DEVELOPMENT BANKS

INTRODUCTION

Since independence, the Government of India has been responsible for setting up a series of institutions for the development of agriculture, industry, international trade, etc. These institutions have come to be called as development banks. Some of them specialise in industry and some in agriculture. In this chapter we are going the discuss on the important development banks in India.

Meaning

A development bank is a multipurpose financial institution with a broad developmental objective. It is defined as a financial concern which is concerned with providing financial assistance to business concerns. The financial assistance is provided in the form of loans, underwriting shares and debentures, investment and guarantee activities. It also performs promotional activities in a variety of ways. It renders several services like discovery of investment projects, preparation of project reports, management services etc. Thus, development banks provide capital, technology and entrepreneurship. Development banks are considered to be the backbone of financial market. Industrial development depends on active role played by the development banks.

Features

Following are the main characteristic features of a development bank:

(a) It is a specialised financial institution.
(b) It provides medium and long-term finance to business units.
(c) Unlike commercial banks. It does not accept deposits from the public.

(d) It is not just a term-lending institution. It is a multi-purpose financial institution.

(e) It is essentially a development-oriented bank. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.

(f) It provides financial assistance not only to the private sector but also to the public sector undertakings.

(g) It aims at promoting the saving and investment habit in the community.

(h) It does not compete with the normal channels of finance, i.e., finance already made available by the banks and other conventional financial institutions. Its major role is of a gap-filler, i.e., to fill up the deficiencies of the existing financial facilities.

(i) Its motive is to serve public interest rather than to make profits. It works in the general interest of the nation.

Important Development Banks in India

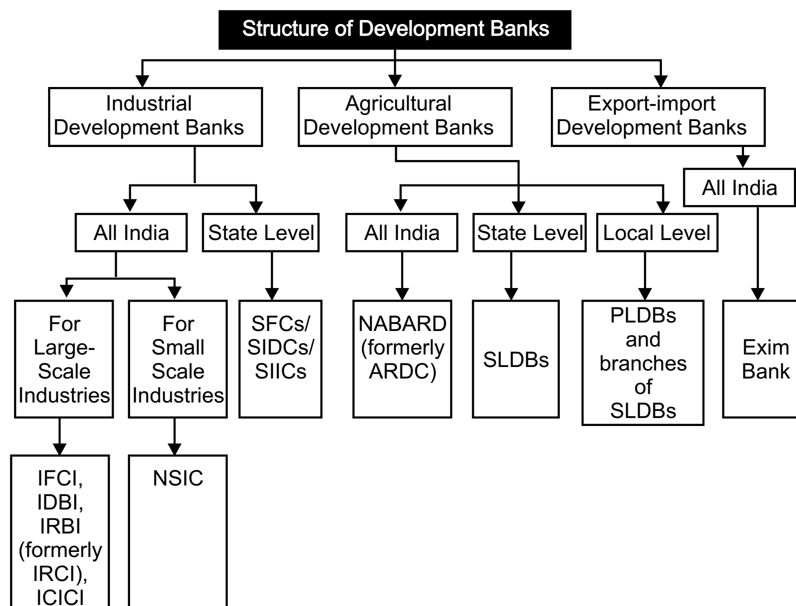
There are about 60 development banks in India. The important development banks functioning in our country are as follows:

1. The Industrial Finance Corporation of India.
2. The Industrial Credit and Investment Corporation of India.
3. The State Financial Corporations.
4. The Industrial Development Bank of India.
5. The Small Industries Development Bank of India.
6. The Industrial Reconstruction Bank of India.
7. The State Industrial Development Corporations.
8. The Unit Trust of India.
9. The Life Insurance Corporation of India.
10. The Export and Import Bank of India.

All these banks are being operated at national, state and local levels. They have been providing all types of financial assistance to business units in the form of loans, underwriting, investment and guarantee operations. They have also undertaken promotional activities. They are thus multi-purpose financial institutions. They have done commendable service for the development of industries in our country.

1. Industrial Finance Corporation of India Ltd.

As stated earlier, the Industrial Finance Corporation of India was the first All India Development Bank to be set up in the country. It was set up in 1948 with the object of providing medium and long-term credit to industry. As pointed out earlier, its role was that of a gap filler as it was not expected to compete with the prevailing channels of industrial finance. It was only meant to supplement their efforts. With effect from July 1, 1993, IFCI has been converted into a public limited company and is now known as Industrial Finance Corporation of India Ltd.



Functions of the IFCI

The Industrial Finance Corporation of India grants financial assistance in the following forms: (1) Granting loans or advances both in rupees and foreign currencies repayable within 25 years, (2) Guaranteeing rupee loans floated in the open market by industrial concerns, (3) Underwriting of shares and debentures of the industrial concerns, (4) Guaranteeing (a) deferred payments in respect of imports of machinery. (b) foreign currency loans raised from foreign institutions, and (c) rupee loans raised from scheduled banks or state cooperative banks by industrial concerns.

In the beginning, the IFCI was expected to extend financial assistance only to industrial concerns in the private and cooperative sectors. Now both public sector and joint sector projects are also eligible for financial assistance from the IFCI. Financial assistance is available from the IFCI for new industrial projects as well as for expansion, renovation modernisation or diversification of the existing ones. This may include the purchase of plant and machinery, construction of factory building and purchase of land for the factory. Normally the IFCI does not provide finance for the repayment of existing liabilities. Its funds are also not available for raising working capital which includes the purchase of raw material.

Financial Resources of IFCI

Financial resources of the IFCI are constituted of the following three components: (i) share capital (ii) bonds and debentures, and (iii) other borrowings. The paid-up capital of the IFCI was initially Rs. 5 crores. Since then it has been increased several times and as on March 31, 2000 stood at Rs. 1,046 crores, Industrial Development Bank of India, commercial banks, the LIC and the cooperative banks account for the share capital of the IFCI. The IFCI has also built-up sizeable reserves. As on March 31, 2000 its reserves stood at Rs. 907 crores.

Apart from the paid-up capital and reserves, the major financial resources of the IFCI are issue of bonds and debentures, borrowing from the government, the Reserve Bank of India and the Industrial Development Bank of India, and foreign loans. The bonds and debentures are guaranteed by the Government of India in respect of repayment of principal and the payment of interest.

Lending Operations of IFCI

The IFCI had started its lending operations on a modest scale in 1948, but over the years with greater accent on industrialization, they have grown both in scope and size. In recent years there has been spectacular rise in the amount of assistance provided to industrial establishments. While in 1970-71, assistance sanctioned was of Rs. 32.2 crores, in 1999-2000, it touched the level of Rs. 2,376 crores. The cumulative assistance sanctioned and disbursed by IFCI as at the end of March 2000 stood at Rs. 49,621 crores. Although IFCI provides assistance to all the private sector, the cooperative sector and the public sector – it is the private sector that is the main recipient of its assistance. For instance, in 1997-98, the private sector accounted for as much as 97.5 per cent of assistance sanctioned followed by joint sector as 2.2 per cent. Public and co-operative sectors accounted for a very negligible amount. However, it is necessary to point out here that IFCI has participated actively in the financing of industrial cooperatives. In fact, it is the financial assistance from the IFCI that has made the experiment of industrial cooperatives successful in this country.

Of the total financial assistance of Rs. 2,376 crores sanctioned in 1999-2000 by IFCI, Rs. 1,721 crores (i.e. 72.4 per cent) was in the form of rupee loans, Rs. 534 crores (i.e. 22.5 per cent) in the form of underwriting and direct subscription and Rs. 121 crores (i.e. 5.1 per cent) in the form of guarantees. Total assistance disbursed in 1999-2000 by IFCI was Rs. 3,262 crores of which the share of rupee loans was as high as 58.4 per cent while that of foreign loans was 7.2 per cent. The share of guarantees was 16.1 per cent.

The IFCI has set up Merchant Banking and Allied Services Department (MBAD) with head office in Delhi and a bureau in Mumbai. MBAD has taken up assignments for capital restructuring, merger and amalgamation, loan syndication with other financial institutions, and trusteeship assignments. It guides entrepreneurs in project formulation and raising resources for meeting project cost, etc.

Appraisal of IFCI's Performance

Opinions differ in respect of the IFCI's working over the past five decades. Looking at the growth of the IFCI's capital financial assistance sanctioned and disbursed and steadily rising profits, its performance seems to be quite impressive. However, an in-depth study reveals certain flaws in its functioning and these have invited criticisms from different quarters. The important criticisms are as follows: (i) As pointed out by the Mahalanobis Committee long ago, the IFCI's lending operations have encouraged concentration of wealth and capital. Even now it is alleged that it pursues a discriminatory policy to the disadvantage of medium and small-sized industrial units, (ii) For a considerable period of time, the IFCI did little to

remove regional imbalances. It is difficult to justify why in the past industrial concerns in Maharashtra got as much assistance as the ones located in five backward States of Assam, Orissa, Kerala, Rajasthan and Madhya Pradesh taken together. However, lately IFCI has provided considerable assistance to units established in backward areas, (iii) In sanctioning assistance the IFCI has not always upheld the national priorities as stated in various plan documents, (iv) It has quite often offered assistance to undertakings which could easily raise resources from the capital market, and (v) The IFCI has failed to exercise necessary control over the defaulting borrowers. The borrowing concerns have not in some cases used the loans for the purposes for which they were sanctioned, and yet IFCI has not initiated any action against them.

The performance of IFCI has been extremely unsatisfactory during recent years. The Capital Adequacy Ratio (CAR) fell to 8.80 per cent in 1999-2000 against the minimum stipulated limit of 9 per cent. The ratio of non-performing assets (NPAs) to net assets in 1999-2000 was as high as 20.70 per cent. As a result, profitability has been affected very adversely.

2. The Industrial Credit and Investment Corporation of India Ltd.

The Industrial Credit and Investment Corporation of India (ICICI) was the second all-India development bank to be established in the country. It was set up in January 1955 and it commenced business in March of the same year. The ICICI differs from two other all-India development banks, viz., the IFCI and IDBI in respect of ownership, management and lending operations. Unlike the IFCI and the IDBI which are public sector development banks, the ICICI is a private sector development bank. Its distinguishing feature is that it provides underwriting facilities which are generally neglected by the other institutions. On April 1, 1996, SCICI Ltd. was merged with ICICI Ltd.

The ICICI provides assistance in various forms, the important ones being: (1) long or medium-term loans or equity participation; (2) guaranteeing loans from other private investment sources; (3) subscription to ordinary or preference capital and underwriting of new issues or securities; and (4) rendering consultancy service to Indian industry in the form of managerial and technical advice.

Financial Resources of ICICI

Initially the resources of the ICICI were rather moderate compared with its present massive resources. Total liabilities and assets of ICICI were Rs. 149 crores in 1971 which rose substantially to Rs. 65,389 crores in 1999-2000. Additional loans from the government and the Industrial Development Bank of India have helped the ICICI in augmenting its resources. The most important source of rupee funds of the ICICI is the issue of bonds and debentures to the public.

Lending Operations of ICICI

In terms of sheer amount of financial assistance provided by the ICICI, its performance has been quite impressive. From Rs. 14.8 crores in 1961-62 and Rs. 43.0 crores in 1970-71,

the assistance sanctioned by the ICICI rose to Rs. 44,479 crores in 1999-2000. The ICICI has provided financial assistance in the form of (i) rupee loans including guarantees; (ii) foreign currency loans; (iii) underwriting of shares and debentures; (iv) direct subscription to shares and debentures; and (v) financial services (in the form of deferred credit, leasing, instalment sale and asset credit). Of the total assistance of Rs. 44,479 crores sanctioned by ICICI in 1999-2000. Rs. 18,362 crores (41.3 per cent) went to corporate finance, Rs. 9,448 crores (21.2 per cent) to infrastructure and Rs. 9,376 crores (21.1) per cent to oil, gas and petrochemicals. Assistance disbursed by ICICI in 1999-2000 stood at Rs. 25,836 crores. Of this Rs. 12,216 crores (47.3 per cent) went to corporate finance, Rs. 5,566 crores (21.5 per cent) to oil, gas and petrochemicals. Rs. 3,611 crores (14.0 per cent) to infrastructure and Rs.3,735 crores (14.5 per cent) to other projects.

The ICICI was originally set up to provide finance to industrial concerns in the private sector, and even now they account for the bulk of the loans sanctioned by this institution. The scope of its operations has been enlarged in recent years by including the projects in the joint, public and cooperative sectors. As far as industry wise assistance is concerned, the major recipients of the financial assistance from the ICICI are non-traditional growth-oriented industries such as chemicals, petrochemicals, heavy engineering and metal products.

The ICICI has joined the consortium of the IDBI, the IFCI and other financial institutions for providing loans on soft terms to a number of industries for modernisation. In this country, quite a large number of enterprises in some traditional industries, particularly cotton textiles, jute, sugar, and cement have been facing serious problems for a long time due to obsolescence. Among the new industries some engineering units urgently need modernisation. They all require financial assistance on soft terms to carry out their plans in respect of replacing the outdated plant and machinery. The consortium of all-India development banks now extends assistance to such industrial units for the purpose of modernisation. The ICICI has been assigned the lead responsibility for industrial enterprises in the engineering group.

In 1983, ICICI commenced leasing operations. It provides leasing assistance for computerisation, modernisation/replacement schemes, equipment for energy conservation, export orientation, pollution control, balancing and expansion.

Appraisal of ICICI's Performance

The ICICI in four and a half decades of its existence has played an important role in providing financial assistance to industrial enterprises in the private sector. Its pioneer work as the underwriting institution in this country has been widely acclaimed. The provision of foreign currency loans is another area where the ICICI has distinguished itself. A large number of growth oriented industries such as chemicals, petrochemicals, heavy engineering and metal products industries are primarily interested in such foreign currency loans for importing capital equipment and it is here that ICICI gives them a helping hand. The ICICI has, however, been rightly criticised for assisting mainly the large units. Moreover, it has done little to promote industrial development in the less developed regions. Its policy of financing

the projects in a few relatively industrially advanced states has, in fact, accentuated regional disparities. However, because of this criticism of its functioning, ICICI has increased its assistance to backward areas in recent years. The ICICI has also participated in setting up Technical Consultancy Organisations in a number of backward states.

3. State Financial Corporations

Industrial Finance Corporation of India was set up in 1948 to cater to the needs of large industrial concerns. It can render financial assistance only to limited companies and co-operative societies. After independence the Government of India realised the need for financial institutions at the state level to assist the promotion and expansion of medium and small-scale industries. The State Financial Corporations Act was born out of this need in 1951. The Act was amended in 1956 and 1962. The State Governments were empowered by the Act to establish financial corporation in their respective regions to foster and stimulate the development of medium and small scale industries.

Functions: The State Financial Corporations are empowered to render financial help in the following forms:

(a) Granting loans and advances to or subscribing to the debentures of industrial concerns repayable within 20 years.
(b) Guaranteeing loans raised by industrial concerns repayable within 20 years.
(c) Underwriting the stocks, shares, debentures, subject to their being disposed off in the market within 7 years.
(d) Guaranteeing deferred payments due from industrial concerns on their purchases of capital goods in India.
(e) Granting soft loans to or participating in the equity of the weaker segments of the medium and small-scale sector.

The State Financial Corporations can grant assistance to public limited companies, partnerships and proprietory concerns. The assistance given to a single concern should not exceed 10% of the paid up capital of the corporation or 15 lakhs whichever is less. The limit is raised to 30 lakhs in the case of limited companies and co-operative societies.

Management: The State Finance Corporation is managed by a Board of Directors. The board consists of 10 members of which three are nominated by the State Government concerned, one by the Reserve Bank of India, one by the I.F.C. and the remaining four are elected by bank, and insurance companies. One member of the board is appointed as the Managing Director.

Resources: State Financial Corporations can raise finance by the following methods:

(a) *Share Capital:* The capital structure of a State Finance Corporation is fixed by the State Government concerned. It is subject to a minimum of Rs. 50 lakhs and a maximum of Rs. 5 crores. Initially the share capital is to be contributed by the State Government concerned, Reserve Bank of India, Co-operative banks and Insurance

companies in a predetermined ratio. Not more than 25 % of the share capital may be allotted to the public. The shares are to be guaranteed by the State Government with regard to both principal and interest. With effect from February 1976 the holding of the RBI in SFCs were transferred to IDBI. The rate of dividend should not exceed 5 per cent per annum.

(b) *Bonds and Debentures:* The corporations are empowered to issue bonds and debentures to supplement their resources. The amount raise through this source should not exceed ten times the amount of their paid-up capital and reserve fund.

(c) *Public Deposits:* The corporations are also empowered to accept public deposits for a period of not less than five years. However, the amount of deposits should not exceed the paid up capital of the corporation.

(d) *Borrowings:* The corporations can also borrow from the Reserve Bank, the IDBI and the State Government concerned. Borrowings from IDBI account for nearly one third of the total resources.

Working: During the last five decades the SFCs have played a significant role in the development of medium and small-scale industries. The following facts and figure speak of their performance and achievements:

(a) There are at present 18 corporations including the Tamil Nadu Industrial Development Corporation. The loans sanctioned from 1971 and 1997 amounted to Rs. 31170 crores. Over 70 % of the total assistance sanctioned by all SFC's is provided to small-scale industries. In 1999-2000, the total assistance sanctioned and disbursed by 18 SFCs stood at Rs. 2,231 crores and Rs. 1,730 crores respectively.

(b) The corporations have directly subscribed to the share capital of a number of companies.

(c) The corporations have also provided guarantees for deferred payments by industrial units for purchase of capital goods.

(d) In recent years, there has been some welcome change in the attitude of SFCs towards the small-scale industries and units in backward areas. The assistance sanctioned and disbursed to the units in these areas is gradually increasing.

(e) The corporations have provided financial assistance on very liberal scale to a number of technical entrepreneurs.

(f) The corporations have also advanced loans in foreign currency for import of capital goods.

(g) Some of the corporations have conducted area surveys and prepared project reports to promote industrial development in backward area.

Critical Review of the Working of SFCs: The SFCs played a significant role in meeting the medium term financial needs of small and medium-scale industries. Food processing, road transport, chemicals, textiles, metal products, machinery and transport equipment industries have been the major beneficiaries of SFC's assistance.

The following are some of the difficulties and limitations faced by the corporations and the suggestions made to solve them:

(a) A major problem of the SFCs is the magnitude of overdues. The default ratio has been increasing, with the result suits filed for recovery of dues are also increasing. There is need to keep a continuous watch on the assisted units.

(b) The financial position of the assisted units needs periodical review and analysis. Assisted units should be compelled to maintain proper books of accounts and not mix up personal accounts with business accounts.

(c) Many firms are not able to offer adequate security for the loans because of defects in titles to property. Further they do not have the resources to fulfil the conditions for the grant of loans.

(d) The units seeking assistance are not familiar with the procedures and formalities to be gone through to get the loans sanctioned.

(e) The corporations should formulate a sound investment policy and maintain healthy investment portfolio. Loans should be sanctioned only after the economic viability of the projects is proved beyond doubt. However there is dearth of technical personnel to examine the soundness of proposed schemes. This deficiency should be set right.

(f) Paucity of funds is one of the major constraints of these corporations. The public response to capital issues of these corporations is not encouraging on account of the low rate of divided and non-marketability of shares. The corporations should issue shares and bonds with attractive terms and rate of interest.

(g) The corporations should pay more attention for the development of industries in backward areas. They should undertake area surveys for preparation of project for industries having development potentialities.

(h) Steps should be taken to see that assistance given is properly utilised. The corporations should not hesitate to take over the management of defaulting concerns, if it is necessary.

(i) Though the rates of interest charged by the corporations are quite reasonable, the cost of borrowing is high for the industrial units on account of high stamp duty, registration fee etc. The State Government should grant some concession in these charges.

Recently some measures have been taken to streamline these corporations and co-ordinate their activities with other financial institutions engaged in industrial finance. The corporations are acting as agents of their respective State Governments for routing funds under the liberalised scheme of assistance to small-scale industries.

The SFCs are the prime sources of block finance to small and medium scale industries. They should adopt a number of measures, as the commercial banks did to increase their volume of assistance to small scale units. Setting up of separate cell to look after the needs of the small scale units, adoption of some selected districts for intensive operations, conducting surveys to identify industrial potential are some of the measures suggested to make the corporations play a more effective and constructive role in the process of industrial growth.

4. The Industrial Development Bank of India

Prior to the establishment of the Industrial Development Bank of India (IDBI), the country had a number of special industrial financing institutions. They had done commendable work in the field of industrial finance, though in terms of range and magnitude they could not adequately meet the demands of the industry. Furthermore, there was a major lacuna in the system. There was no apex organisation to coordinate the functions of various industrial financing institutions. V.V. Bhatt rightly stated that the country needed a central development banking institution for providing "dynamic leadership in the task of promoting a widely diffused and diversified and yet viable process of industrialisation." It was under these circumstances that IDBI was set up in July 1964. The IDBI was initially set up as a wholly owned subsidiary of the Reserve Bank of India. In February 1976 the IDBI was made an autonomous institution and its ownership passed on from the Reserve Bank of India to the Government of India.

The IDBI has rightly been designated as the apex organisation in the field of development banking. It not only has organisational links with other development banks but it also renders some such services to them which only an apex organisation is expected to perform. In the first place, it provides refinance against loans granted to industrial concerns by other development banks like the IFCI, the SFCs and so on and rediscounts their machinery bills. Secondly, it subscribes to the share capital and bond issues of the IFCI, the ICICI, the SFCs and the IIBI. Apart from these linkages, the IDBI plays the role of a coordinator at all-India level. For this purpose, a machinery has been evolved and regular meetings of the Heads of various financial institutions are held under its leadership. Thus, the IDBI enjoys a unique position in India's development banking system. It occupies the same place in the field of development banking as is occupied by the RBI in the field of commercial banking.

Financial Resources of IDBI

The operations of the IDBI have grown over the years and so have its resources. The main sources of its funds are share capital, reserves, bonds and debentures issues, deposits from companies and Certificates of Deposits, and borrowings from the Reserve Bank of India and Government of India. The total resources of IDBI amounted to Rs. 72,169 crores in 1999-2000. Of this, the share of bonds and debentures was Rs. 43,976 crores (60.1 per cent). Other sources (inclusive of deposits from companies and Certificates of Deposits) was the second most important source accounting for Rs. 10,096 crores (21.4 per cent) of total resources. The share of reserves and reserve funds was Rs. 8,558 crores (12.8 per cent) while borrowings from the RBI and government stood at Rs. 3,106 crores (6.3 per cent).

Cumulative Assistance by IDBI

The IDBI is the leading development bank in India. Its progress has been spectacular in whole of the period of its existence but particularly so in recent years. The cumulative assistance sanctioned by IDBI till the end of March 2000 aggregated Rs. 2,16,401 crores.

Considering the underdeveloped nature of the capital market and the difficulties which a large number of industrial firms encounter in raising funds from the market, this quantum of assistance is not small. In fact, it is almost equal to the amount of financial assistance provided by all other special industrial financing institutions taken together. The amount of assistance disbursed by IDBI till the end of March 2000, from the date of establishment, totalled Rs. 1,38,793 crores. During 1999-2000, assistance sanctioned and disbursed by IDBI stood at Rs. 28,308 crores and Rs. 17,059 crores respectively.

Composition of Financial Assistance

The state pertaining to the IDBI enables it to have considerable flexibility in its operations. It, therefore, can provide financial assistance to all kinds of big, medium and small enterprises. In respect of the size of loans, there are virtually no restrictions on it. Moreover, it is completely free to use its own discretion in respect of the security to be obtained against the loan sanctioned. Its assistance can be broadly classified into the following categories:

1. **Direct Financial Assistance to Industrial Enterprises:** The IDBI provides direct financial assistance to industrial concerns in the form of loans, underwriting and direct subscription to shares and debentures and guarantees. The policy framework of the IDBI in respect of direct financing has been decided by its apex position. It, therefore, generally avoids competing with other special industrial financing institutions. It, in fact, acts as the lender of the last resort. The IDBI's direct assistance to industrial enterprises in the entire period of its existence has accounted for about one-third of its total assistance. Loans as a form of direct finance constitute the major part of the IDBI's financial assistance to the industry.
2. **Indirect Financial Assistance to Industries:** A major part of the IDBI's assistance is routed through some other financial institutions including the State Financial Corporations, State Industrial Development Corporations and Commercial Banks. This form of assistance is generally characterised as indirect financial assistance. The IDBI's indirect assistance can be broadly classified into four categories: (a) refinance of industrial loans, (b) rediscounting of bills, (c) subscription to shares and bonds of financial institutions, and (d) seed capital assistance.
3. **Assistance to Backward Areas:** The IDBI has initiated certain financial and non-financial measures to encourage industries in backward areas. Financial measures are mainly of three types: (a) direct financial assistance in the form of loans at concessional rates, longer initial grace period, etc., (b) concessional refinance assistance to projects in backward areas; and (c) special concessions to projects in North-Eastern area under the bill rediscounting scheme. Non-financial measures aim at helping potential entrepreneurs in identifying and formulating viable projects, technical assistance etc.

   Total assistance sanctioned by IDBI in 1999-2000 was Rs. 28,308 crores. Of this, the share of direct assistance was Rs. 26,350 crores (93.1 per cent), refinance of industrial loans Rs. 242 crores (0.9 per cent), and bills finance Rs. 723 crores (2.6 per cent). The

share of rupee loans in direct assistance of Rs. 26,350 crores sanctioned by IDBI in 1999-2000 was Rs. 8,914 crores (i.e., as high as 34 per cent).

Industry-wise analysis of IDBI's financial assistance reveals that core and other manufacturing sectors accounted for bulk of the assistance sanctioned and disbursed. Core sector includes industries such as iron and steel, oil exploration and refining, cement and fertilizer. Other major industries that received large sanctions are: chemicals and chemical products, textiles, electronic and electrical products, food manufacturing and artificial fibres.

Promotional Functions of the IDBI

Apart from providing financial assistance to industry, the IDBI performs certain promotional functions as well. These include provision of training in project evaluation and development of entrepreneurship. A special scheme has been initiated for "no industries districts." Under this scheme, IDBI has done surveys to study the industrial potential of no industry districts. The programme is to arrange training for potential entrepreneurs in these districts besides giving financial, technical and administrative assistance to selected projects. It also runs a Technical Consultancy Organisation (TCO). Besides doing feasibility studies, project appraisals, industrial and market potential surveys, etc., TCO has also made considerable progress in training new entrepreneurs. The IDBI is also supporting a number of inter-institutional groups which provide a forum for discussions on industrial development programmes.

Critical Appraisal

The IDBI was set up three and a half decades ago to function as an apex institution in the field of development finance. Judged by its assistance measured in quantitative terms, the performance of the IDBI looks quite impressive. Over the years not only the amount but also the range and pattern of assistance have grown. This is a significant contribution when we view it in the light of the fact that capital market in the country is still not very much developed. However, without undermining the importance of the contributions made by the IDBI, it must be stated that it has failed to develop itself as a true development bank. Its accent on providing loans and treating underwriting of shares and debentures of industrial concerns as a secondary activity is not very appropriate. Secondly, in spite of all its pretensions in providing assistance to projects in backward areas and also to the small-scale sector, the largest beneficiaries of the assistance provided by the IDBI are big industrial concerns. Thus, the distributional consequences of its working are in all probability not very healthy. Finally, the IDBI has mainly concentrated on providing financial assistance. The promotional and consultancy work has not been assigned the same importance as financial assistance. Thus there is need for a change in the approach of the IDBI towards industrial development.

The financial performance of IDBI in recent years has also raised many eyebrows as its profitability has been declining. Moreover, the ratio of its non-performing assets to net assets rose to as high 13.40 per cent in 1999-2000. These are warning signals for IDBI.

5. Small Industries Development Bank of India

With a view to ensuring larger flow of financial and non-financial assistance to the small scale sector, the Government of India announced in the Budget for 1988-89, its decision to establish Small Industries Development Bank of India (SIDBI) as a subsidiary of IDBI. The SIDBI Act was passed by the Parliament on October 1989 and the bank commenced its operations from April 2, 1990. To equip SIDBI to play its apex role in SSI credit provision more effectively, the Union Budget 1998-99 passed the delinking of SIDBI from IDBI and transferring of IDBI shareholding in SFCs to SIDBI.

Financial Resources of SIDBI

The SIDBI commenced its operations with an initial paid-up capital of Rs. 250 crores and by taking over the outstanding portfolio of IDBI relating to small-scale sector held under Small Industries Development Fund as on March 31, 1990 amounting to Rs. 4,200 crores. The paid up capital was subsequently raised to Rs. 450 crores. The financial resources of SIDBI aggregated Rs. 16,561 crores in 1999-2000. Of these, borrowings from RBI, Government of India and other sources contributed Rs. 8,012 crores (i.e., 48.4 per cent). Bonds and debentures contributed Rs. 2,437 crores (14.7 per cent).

Financial Assistance by SIDBI

With a view to ensuring larger flow of assistance to the small-scale units, the immediate thrust of SIDBI was on (a) initiating steps for technological upgradation and modernisation of existing units; (b) expanding the channels for marketing the products of the small-scale sector; and (c) promotion of employment-oriented industries especially in semi-urban areas to create more employment opportunities and thereby checking migration of population to urban areas. SIDBI provides assistance to the small-scale units through the existing credit delivery system comprising State Financial Corporation, State Industrial Development Corporations, Commercial Banks, Co-operative Banks and Regional Rural Banks. The major activities of SIDBI are: (i) refinance of loans and advances; (ii) discounting and re-discounting of bills; (iii) extension of seed capital/soft loans; (iv) granting direct assistance and refinancing of loans; (v) providing services like factoring, leasing etc.; and (vi) extending financial support of State Small Industries Development Corporations. During 1999-2000, SIDBI sanctioned assistance worth Rs. 10,265 crores of which assistance worth Rs. 6,964 crores was disbursed. Till end of March 2000, cumulative sanctions and disbursements by SIDBI were of the order of Rs. 43,886 crores and Rs. 33,666 crores respectively.

6. The Industrial Reconstruction Bank of India (IRBI)

To provide financial assistance as well as to revive and revitalise sick industrial units in public/private sectors, an institution called the Industrial Reconstruction Corporation of India (IRCI) was set up in 1971 with a share capital of Rs. 10 crores. In March 1985, it was converted into a statutory corporation called the Industrial Reconstruction Bank of India (IRBI), with an authorised capital of Rs. 200 crores and a paid up capital of Rs. 50 crores.

The following functions were laid down for the IRBI:

(a) to provide financial assistance to sick industrial units,

(b) to provide managerial and technical assistance to sick industrial units,

(c) to secure the assistance of other financial institutions and government agencies for the revival and revitalisation of sick industrial units,

(d) to provide merchant banking services for amalgamation, merger, reconstruction, etc.,

(e) to provide consultancy services to the banks in the matter of sick units, and

(f) to undertake leasing business.

In a similar fashion, the IRBI is to function as the principal credit and reconstruction agency for industrial revival and co-ordinate the activities of other institutions engaged in the revival of industries and also to assist and promote industrial development and rehabilitation of industrial concerns.

The IRBI is empowered to take over the management of assisted sick industrial units, lease them out or sell them as running concerns or to prepare schemes for reconstruction by scaling down the liabilities with the approval of the Government of India.

During 1986-87, the IRBI sanctioned a total assistance of Rs. 148.9 crores and disbursed Rs. 946 crores by way of term loans to industrial units for essential capital expenditure relating to modernisation, diversification, renovation, expansion, etc.

During 1995-96, the sanctions of IRBI amounted to Rs.897 crores. Its cumulative sanctions amounted to Rs. 3,521 crores and disbursement Rs.2,404 crores. The sanctions of IRBI amounting to Rs. 1044 crores during 1998-99, indicated a growth of 15.3 per cent. The disbursements at Rs. 529 crores registered a growth of 32.9 per cent.

7. The State Industrial Development Corporations (SIDCs) and the State Industrial Investment Corporations (SIICs)

Since 1960, the State Industrial Development Corporations and State Industrial Investment Corporations (SIDCs/SIICs) have been set up by state governments as counterparts of the NIDC. Presently, there are 28 such institutions in all.

Besides financial assistance, their main function is to promote industries. They arrange for land, put up industrial estates, construct roads, arrange for the supply of water and electric power, arrange for licences for industrial units and so on in order to promote industries, especially in backward areas.

Organisational deficiencies, insufficient and untrained staff, defaults in payment of dues are the major weaknesses of these institutions.

During 1995-96 their total financial assistance sanctions amounted to Rs. 20,488 crores and disbursement Rs. 1,383 crores.

8. Unit Trust of India

The Unit Trust of India is a statutory public sector investment institution which was set up in February 1964 under the Unit Trust of India Act 1963. This institution began operations in July 1964. UTI was set up with the object of stimulating and pooling the savings of middle and low income groups and to enable them to share the benefits and prosperity of the fast growing industrialisation in the country. This two-fold objective has been achieved by three following approaches:

(a) By selling its units under the various schemes of the Trust among as many investors as possible in the different parts of the country.
(b) By investing the sale proceeds of the units in industrial and corporate securities.
(c) By paying dividends to those who have purchased the units of the Trust.

The main source of funds of the Unit Trust of India (UTI) is the sale of units to the public under many schemes. The face value of the 'unit' sold by the Trust is not less than Rs. 10 or more than Rs. 100. There is no limit to the number of units which can be purchased by the unit holders.

At the time of establishment of the Trust, the capital was Rs. 5 crores, divided into 1,000 certificates of the face value of Rs. 50,000 each. These certificates were subscribed by the various institutions in the following way:

Reserve Bank of India	Rs. 2.5 crores
State Bank of India and its subsidiaries	Rs.75 lakhs
Life Insurance Corporation of India	Rs. 75 lakhs
Others (the scheduled commercial banks, the other financial institutions)	Rs. 1 crore.

The UTI which was an associate institution of the RBI till February 15, 1996, became an associate institution of the Industrial Development Bank of India on February 16, 1996. By doing so, the capital of Rs. 2.5 crores which was held by the Reserve Bank of India earlier, has been transferred to the Industrial Development Bank of India.

The Management of the UTI is vested in a Board of Trustees, comprising a chairman appointed by the Reserve Bank, four trustees also nominated by the Reserve Bank, one trustee nominated by the Life Insurance Corporation of India and two trustees elected by the other contributing financial institutions.

Present Position

As on September 30, 1999, UTI managed 28 equity schemes with unit capital of about Rs. 6,155 crores, and market value of investment.

Rs. 10,816 crores. During the quarter ending September 1999, 21 equity schemes of UTI out-performed the BSE Sensex, which registered an increase of 15.1 per cent. The number of income/debt schemes of UTI stood at 49 and the total investible funds of these schemes amounted to Rs. 35,467 crores as on September 30, 1999. Total investible funds of the UTI stood at Rs. 74,291 crores as on June 30, 2000. As on June 30, 1999 investments in debt instruments, including money market instruments, was Rs. 23,600 crores (71%) and in equity Rs. 9724 crores (29%). The corresponding figures rose to Rs. 25,026 crores (Market Value Rs. 25,649 crores) and Rs. 10,441 crores (Market value Rs. 11,745 crores) as on September 30, 1999. The portfolio restructuring process initiated last year has begun bearing fruits in terms of improved performance of core equity portfolio and the improvement in credit quality of debt.

9. Life Insurance Corporation of India (LIC)

The Life Insurance Corporation of India came into existence on July 1, 1956 and the Corporation began to function on September 1, 1956. The Corporation gets a large amount as insurance premium and has been investing in almost all sectors of the economy, viz., public sector, private corporate sector, co-operative sector, joint sector and now it is one of the biggest term lending institutions in the country.

The paid-up capital of the Corporation is Rs. 5 crores. The Corporation has an accumulated Life Insurance Fund of over Rs. 4,500 crores. The LIC of India plays an important role in the capital market and is the largest institutional investor. Like banks, the LIC is also a captive investor in government bonds. At the end of March 1992, Rs. 27,150 crores was invested by LIC in government securities excluding treasury bills, small savings and other kinds of bonds. Under the law the LIC is required to hold 87.5% of its assets in the form of government and other approved securities and loans to approved authorities for such social schemes as housing, electricity, water supply etc., and remaining 12.5% can be invested in the private sector.

The Corporation subscribes to and underwrites the shares, bonds and debentures of several Financial Corporations and Companies and grants term loans. It maintains close contacts with other financial institutions such as Industrial Development Bank of India, Unit Trust of India, Industrial Finance Corporation of India etc., for co-ordination of its investments.

The LIC is a very powerful factor in the securities market in India. It subscribes to the share capital of companies both preference and equity and also to debentures and bonds. Its share holding extends to a majority of large and medium-sized non-financial companies and is significant in size. There is no doubt, the Corporation acts as a kind of downward stabiliser of the share market, as the continuous inflow of fresh funds enables it to buy even when the share market is weak. About 50% financial assistance is provided by the LIC in the form of rupee loans, about 20% in the underwriting shares (preference and ordinary) and about 25% in underwriting debentures.

Present Position

The financial assistance sanctioned by LIC during the year 1998-99 through term loans and underwriting of shares and debentures of corporate sector amounted to Rs. 2730 crores while disbursements aggregated Rs. 2804 crores, registering a significant growth of 43.7 per cent in sanctions and 93.5 per cent in disbursements.

The investment of LIC during 1998-99 at Rs. 7348 crores recorded a rise of 21.8 per cent as compared with an increase of 16.4 per cent during 1997-98.

Investment By LIC

Type of Assistance	As at the end of March		Net Changing during April-March	
	1997	1998	1997-98	1998-99
1. Public Sector	49,416.3	56,063.7	5,720.8	6647.4
2. Private Sector	9107.6	9705.4	526.5	597.8
3. Joint Sector	525.8	532.4	18.4	6.6
4. Co-operative Sector	2007.4	2,103.8	92.0	96.4
Total (1 to 4) of which	61,057.1	68,450.3	6,357.7	7,348.2
(a) Stock Exchange Securities	43,570.4	47,913.8	5,407.3	5,905.7
(b) Loans	16,137.9	17,088.4	761.8	903.9
(c) Others	1,348.8	3,403.1	188.6	538.6

Source: LIC of India.

Of the total investments of Rs. 1,39,032 crores made by LIC as at the end of March 2000, public sector accounted for the major share of Rs. 1,17,059 crores. While private sector got Rs. 19,268 crores. The balance went to co-operative sector and joint sector.

Highlights of the Corporation as on 31.3.2002

	Item	Amount
1.	Total Income	Rs. 73,430.95 crores
2.	Total Premium Income	Rs. 49,613.28 crores
3.	Income from Investment	Rs. 22,807.29 crores
4.	Miscellaneous Income	Rs. 1,010.38 crores
5.	Total Payments to Policy holders	Rs. 17,480.78 crores
6.	Total Life Fund	Rs. 2,33,289.03 crores
7.	Total Assets of the Corporation	Rs. 1,93,621.69 crores

Source: LIC of India.

10. The Export-Import Bank of India (EXIM Bank)

The Export-Import Bank of India (EXIM Bank) which was established on January 1, 1982 by an Act of Parliament, commenced operation from March 1, 1982. The export loans and guarantee portfolio of the IDBI was transferred on March 1, 1982 to the EXIM Bank, which assumed funded liability of Rs. 169.2 crores and non-funded liability in the form of export guarantees of Rs. 336.4 crores under the General Fund and Rs. 2.5 crores under the Development Assistance Fund, now called Export Development Fund.

Objectives: The Export-Import Bank of India Act 1981 (Act 28 of 1981) defines the objectives as "an Act to establish a corporation to be known as the Export-Import Bank of India for providing financial assistance to exporters and importers, and for functioning as the principal financial institution for co-ordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country's international trade and for matters connected therewith or incidental thereto."

Capital: As per Section 4 of the Export-Import Bank of India Act, 1981, the authorised capital of the EXIM Bank is Rs. 200 crores. The Government of India may increase the said capital to Rs. 500 crores by notification. The EXIM Bank can raise its resources by issue and sale of bonds and debentures, borrowing from the RBI, borrowing from other institutions approved by the Government of India, acceptance of deposits and loans in foreign currency from any bank or financial institution in any foreign country with the previous approval of the Government of India.

Functions of the EXIM Bank

(a) EXIM Bank provides direct financial assistance to exporters of plant, machinery and related services in the form of medium-term credit.
(b) The bank gives term loans/deferred payment guarantee for project cost financing of units registered as 100 per cent export-oriented units.
(c) The bank provides rediscount of export bills for a period not exceeding 90 days against short-term usance export bills discounted by commercial banks.
(d) The bank gives facilities for deemed exports in case of specified transactions within India. Consequently, the foreign exchange earnings or foreign exchange savings are determined by Government of India.
(e) The bank gives overseas buyers credit to foreign importers for import of Indian capital goods and related services.
(f) The bank provides facilities to overseas buyers for Indian consultancy, technology and other related services.

Present Position

Exim Bank sanctioned Rs. 3,055 crores and disbursed Rs. 2,637 crores under various lending projects during 1998-99. At end March 1999 the cumulative outstandings of the Exim Bank aggregated Rs. 3.311 crores, an increase of 13.5 per cent over the year.

Region-wise analysis of the operations of Exim Bank showed that West Asia accounted for the largest share of sanctions and disbursements at Rs. 104 crores and Rs. 63 crores respectively during 1998-99.

Exim Bank's resources as on March 31, 1999 aggregated Rs. 4104 crores inclusive of paid-up capital of Rs. 500 crores and resumes of Rs. 400 crores. Exim Bank raised Rs. 173 crores through private placement of bonds for the first time in the Indian Capital Market besides mobilising funds by way of rupee fixed deposits, certificates of deposits etc.

Region-wise operations of Export-Import Bank of India

Rs. crores

	1998-99			
Regions	**Sanctions**	**% share**	**Disbursements**	**% share**
1. South Asia	2.4	0.8	12.6	7.2
2. Americas	15.4	5.0	5.6	3.2
3. West Asia	99.4	32.4	55.8	30.5
4. South-East Asia	34.4	11.2	52.7	29.9
5. Europe and CIS	71.0	23.0	30.9	17.5
6. Sub-Saharan Africa	81.1	26.3	20.6	11.7
7. North Africa	4.6	1.5	-	-
Total	308.1	100.0	176.2	100.0

Source: Export-Import Bank of India.

Conclusion

From the above discussion, it is clear that the term development bank broadly includes all types of institutions which provide long-term loans, equity capital and debenture capital to the development of the economy in general. The main objective of a development bank is that of financing development activities in the country.

Questions for Discussion

1. What are development banks? Discuss the features of development banks.
2. Explain the role of the IFC in providing funds to industries.
3. Discuss the part played by Industrial Credit and Investment Corporation of India in financing industries in India.
4. Discuss the part played by the IDBI as the apex organisation in the Industrial Finance Structure.

5. What are the functions of the Small Industries Development Bank of India? Discuss its progress and growth.
6. Explain the functions and working of State Financial Corporations.
7. Describe the functions of the Export-Import Bank of India.
8. Describe the functions of the UTI and LIC.

8

BANKER AND CUSTOMER

INTRODUCTION

Banking industry occupies an important place in a nation's economy. A bank is an indispensable institution in a modern society. One cannot think of the development of any nation without the active assistance rendered by financial institutions. Banks, in fact, do finance trade, industry and commerce. The modern business and the entrepreneur cannot carry on the commercial activities without the different methods of financing done by the banks. Gone are the days when borrowing was criticised and objected to and the borrower was looked down upon. But today, the time and circumstances have changed. It is natural that every businessman has to change according to the new challenges. Right from small businessman, up to the biggest business tycoon, they invariably depend upon finances of different types given by the banks. Therefore, one has to accept that the banking industry play a vital role in every field and at every juncture of the business.

This chapter deals with the relationship that exists between the banker and customer. All the legal aspects associated with these two vital organs of the banking operations are discussed. The relationship between the customer and the banker is vital. The relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account. The relationship stands established as soon as the agreement or contract is entered into. The nature of the relationship depends upon the state of the customer's account.

Before we take up the relationship that exists between a banker and his customer, let us understand the meaning of the terms 'banker' and 'customer'.

Meaning and Definition of a Banker

The term 'banker' refers to a person or company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honouring cheques

drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts.

There are differences of opinion regarding the meaning of the term banker. We have discussed here some of the important ones.

1. **Sheldon H.P.:** "The function of receiving money from his customers and repaying it by honouring their cheques as and when required is the function above all other functions which distinguishes a banking business from any other kind of business."
2. **Sir John Paget:** "No person or body corporate or otherwise can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques and collect cheques crossed and uncrossed for his customers."
3. **G. Crowther:** "A banker is a dealer in debt, his own and other people."
4. **Macleod:** "The essential business of banker is to buy money and debts, by creation of other debts. A banker is therefore essentially a dealer in debts or credit."
5. **Dr. H.L. Hart:** "A banker or bank is a person or company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts."
6. **Indian Banking Regulation Act:** Under Section 5(1) (b and c) of the Banking Regulation Act 1949, "Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. Banking company means any company which transacts the business of banking in India."

   From the definitions given above, it is clear that if any person or institution fulfils the following conditions, it will satisfy the definition of a banker or a banking company.

   (a) Accepting of deposits from the public, repayable on demand or otherwise. The deposits may be of different types, current, savings, fixed etc.
   (b) Such deposits must be withdrawable by cheques, drafts, order or otherwise.
   (c) Any money accepted as deposits must be for the purpose of lending or investment.
   (d) Performance of banking business as the main business.

According to Section 6 of the Act, a banker, apart from the usual services, may also engage in any one or more of the following forms of business namely:

1. The borrowing, raising or taking up of money, the lending or advancing of money either upon or without security.
2. The drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debenture, certificates, scrips, and other instruments.

3. The granting and issuing of the letters of credit, traveller's cheques and circular notes.
4. The buying, selling and dealing in bullion and specie.
5. The buying and selling of foreign exchange including foreign bank notes.
6. The acquiring, holding, issuing on commission, underwriting and dealing in stocks, funds, shares, debentures, bonds, obligations, securities and investments of all kinds.
7. Acting as agents for any government or local authority.
8. The purchasing and selling of bonds, scrips and other forms of securities on behalf of constituents or others.
9. Contracting for public and private loans and negotiating and issuing the same.
10. The receiving of all kinds of bonds, scrips or valuable on deposits or for safe custody or otherwise.
11. The providing of safe deposit vaults.
12. The collecting and transmitting of money and securities.
13. The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of state, municipal or other loans or of shares stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue.
14. Carrying on and transacting every kind of guarantee and indemnity business.
15. Managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims.
16. Undertaking and executing trusts.
17. Undertaking the administration of estates as executor, trustee or otherwise.
18. The acquisition, construction, maintenance and alternation of any building or works necessary or convenient for the purposes of the company.
19. Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company.
20. Any other form of business which the Central Government may, by notification in the official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

A banking company is not permitted to engage in any form of business other than those referred to above.

Meaning and Definition of a Customer

The term 'customer' of a bank is not defined by law. In the ordinary language, a person who has an account in a bank is considered its customer.

The term customer also presents some difficulty in the matter of definition. There is no statutory definition of the term either in India or in England. However, the legal decisions on the matter throw some light on the meaning of the term.

According to an old view, as expressed by Sir John Paget, "to constitute a customer, there must be some recognizable course or habit of dealing in the nature of regular banking business...... It has been thought difficult to reconcile the idea of a single transaction with that of a customer that the word predicates, even grammatically, some minimum of custom, antithetic to an isolated act." According to this view, in order to constitute a customer of a bank, two conditions are to be fulfilled.

(a) There must be some recognizable course or habit of dealing between the customer and the banker.

(b) The transactions must be in the form of regular banking business.

Further, for a person to be a customer of a bank, he should have some sort of account with the bank and the initial transaction in opening an account would not constitute the relation of banker and customer; there should be some kind of continuity. The concept of duration does not hold good any longer. At present to constitute a customer, duration is not essential.

According to Dr. Hart "a customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such." Supporting this view point, the Kerala High Court observed: (Central Bank of India Ltd., Bombay Vs V. Gopinathan Nair and others – A.I.R., 1970, Kerala 74).

"Broadly speaking, a customer is a person who has the habit of resorting to the same place or person to do business. So far as banking transactions are concerned he is a person whose money has been accepted on the footing that the banker will honour up to the amount standing to his credit, irrespective of his connection being of short or long standing."

Thus, a person who has a bank account in his name and for whom the banker undertakes to provide the facilities as a banker is considered to be a customer. It is not essential that the account must have been operated upon for some time.

A more acceptable view is that expressed in Ladbroke Vs Todd (1914, 30, TLR., 433). According to the Learned Judge: "The relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection. It is not essential that the person should have drawn on any money or even that he should be in a position to draw any money." Therefore, neither the number of transactions nor the period during which business has been conducted between the parties is material in determining whether or not a person is a customer.

In a later case that took place between official Assignee Vs Natesam Pillai: (Indian case), According to learned judge "the fact that person had no prior banking transaction with the bank would not by itself exclude the possibility of his becoming a customer when he paid in the amount."

All these court decisions lay stress on the fact that the customer need not have continuous transactions with the bank to become a customer. Mere opening, any type of account will satisfy the basic condition to become a customer. His position must be such that transactions

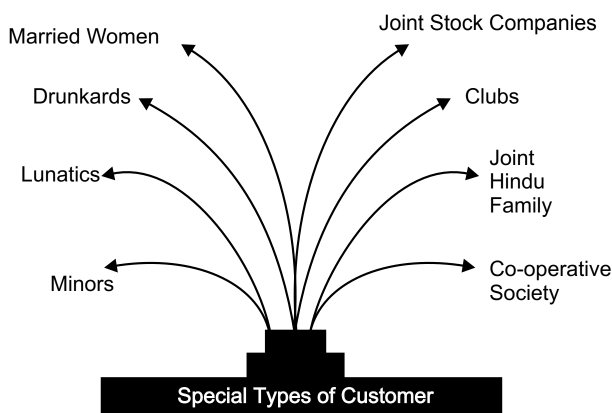
are likely to become frequent. When the accounts are opened with the bank, there will be an implication that the person is likely to operate the account frequently.

Thus, in order to constitute a person as a customer, he must satisfy the following conditions:

1. He must have an account with the bank – i.e., saving bank account, current deposit account, or fixed deposit account.
2. The transactions between the banker and the customer should be of banking nature i.e., a person who approaches the banker for operating Safe Deposit Locker or purchasing travellers cheques is not a customer of the bank since such transactions do not come under the orbit of banking transactions.
3. Frequency of transactions is not quite necessary though anticipated.

Special Types of Customers

Special types of customers are those who are distinguished from other types of ordinary customers by some special features. Hence, they are called special types of customers. They are to be dealt with carefully while operating and opening the accounts. They are:



1. **Minors:** Under the Indian law, a minor is a person who has not completed 18 years of age. The period of minority is extended to 21 years in case of guardian of this person or property is appointed by a court of law before he completes the age of 18 years.

   According to Indian Contract Act, a minor is recognised as a highly incompetent party to enter into legal contracts and any contract entered into with a minor is not only invalid but voidable at the option of the minor. The law has specially protected a minor merely because his mental faculty has not fully developed and as such, he is likely to commit mistakes or even blunders which will affect his interests adversely. It is for this reason, the law has come to the rescue of a minor.

   A banker can very well open a bank account in the name of a minor. But the banker has to be careful to ensure that he does not open a current account.

If a current account is opened and stands overdrawn inadvertently, the banker has no remedy against a minor, as he cannot be taken to a court of law. It is for this reason that the banker should be careful to see that he invariably opens a savings bank account.

The conditions for opening and maintaining accounts in the names of the minors are:

1. The minor should have attained the age of discretion, i.e., he must be about 14 years of age. He must be capable of understanding what he does.
2. The minor should be able to read and write.
3. The minor should be properly introduced. The account opening form should be signed by the minor in the presence of a bank officer who should be able to identify the minor. The date of birth of the minor should be recorded in the account opening form.
4. Banks usually stipulate limits up to which deposits in such accounts can be accepted.
5. Amount tendered by the minor should as far as possible be in cash.
6. In case of time deposits, the amount should be paid in cash on maturity. Prepayment cannot be allowed. Periodical payment of interest on deposits may be made to the minor.

Legal Provisions Regarding Guardianship of a Minor

According to Hindu Minority and Guardianship Act, 1956, a Guardian is one who is recognised by law to be one of the following:

(a) *Natural Guardian:* According to Section 6 of the Hindu Minority and Guardianship Act, 1956, in case of a minor boy or an unmarried girl, his/her father and after him the mother shall be the natural guardian. In case of a married girl (minor), her husband shall be the natural guardian. The terms father or mother do not include step-father or step-mother.

(b) *Testamentary Guardian:* A Hindu father, who is entitle to act as the natural guardian of his minor legitimate children may, by will, appoint a guardian for any of them in respect of the minor's person or property. Such guardian acts after the death of the father or the mother.

(c) *Guardian Appointed by Court:* A guardian may be appointed by the court under the Guardians and Wards Act, 1890, but the court shall not be authorised to appoint or declare a guardian of the person of a minor, if his father is alive and is not, in the opinion of the court, unfit to be guardian of the person of the minor. Similar is the case of a minor girl, whose husband is not, in the opinion of the court, unfit to be guardian of her person. Thus the father (or the husband in case of a married girl) is exclusively entitled to be the guardian.

2. **Lunatics:** A lunatic or an insane person is one who, on account of mental derangement, is incapable of understanding his interests and thereby, arriving at rational judgement.

Since a lunatic does not understand what is right and what is wrong, it is quite likely that the public may exploit the weakness of a lunatic to their advantage and thus deprive him of his legitimate claims. On account of this, the Indian Contract Act recognises that a lunatic is incompetent to enter into any contract and any such contract, if entered into, is not only invalid but voidable at the option of the lunatic.

Since a lunatic customer is an incompetent party, the banker has to be very careful in dealing with such customers. Bankers should not open an account in the name of a person of unsound mind. On coming to know of a customer's insanity, the banker should stop all operations on the account and await a court order appointing a receiver. It would be dangerous to rely on hearsay information. The bank should take sufficient care to verify the information and should not stop the account unless it is fully satisfied about the correctness of the information. In case a person suffers from a temporary mental disorder, the banker must obtain a certificate from two medical officers regarding his mental soundness at the time of operation on the account.

3. **Drunkards:** A drunkard is a person who on account of consumption of alcoholic drinks get himself intoxicated and thereby, loses the balance over his mental faculty and hence, is incapable of forming rational judgement.

   The law is quite considerable towards a person who is in drunken state. A lawful contract with such a person is invalid. This is for the simple reason that it is quite likely that the public may exploit the weakness of such a person to their advantage and thus, deprive him of his legitimate claims.

   A banker has to be very careful in dealing with such customers. There cannot be any objection by a banker to open an account. In case a customer approaches the banker for encashment of his cheque especially when he is drunk, the banker should not make immediate payment. This is because the customer may afterwards argue that the banker has not made payment at all. Therefore, it is better and safer that the banker should insist upon such a customer getting a witness (who is not drunk) to countersign before making any payment against the cheque.

4. **Married Women:** An account may be opened by the bank in the name of a married woman as she has the power to draw cheques and give valid discharge. At the time of opening an account in the name of a married woman, it is advisable to obtain the name and occupation of her husband and name of her employer, if any, and record the same to enable detection if the account is misused by the husband for crediting therein cheques drawn in favour of her employer.

   In case of an unmarried lady, the occupation of her father and name and address of her employer, if any, may be obtained and noted in the account opening form.

   If a lady customer requests the bankers to change the name of her account opened in her maiden name to her married name, the banker may do so after obtaining a written request from her. A fresh specimen signature has also to be obtained for records.

   While opening an account of a purdah lady, the bank obtains her signature on the account opening form duly attested by a responsible person known to the bank. It is

advisable to have withdrawals also similarly attested. In view of practical difficulties involved, it would be better not to open accounts in the names of purdah ladies.

5. **Insolvents:** When a person is unable to pay his debts in full, his property in certain circumstances is taken possession of by official receiver or official assignee, under orders of the court. He realises the debtor's property and reteably distributes the proceeds amongst his creditors. Such a proceeding is called 'insolvency' and the debtor is known as an 'insolvent'.

   If an account holder becomes insolvent, his authority to the bank to pay cheques drawn by him is revoked and the balance in the account vests in the official receiver or official assignee.

6. **Illiterate Persons:** A person is said to be illiterate when he does not know to read and write. No current account should be opened in the name of an illiterate person. However, a savings bank account may be opened in the name of such a person. On the account opening form the bank should obtain his thumb mark in the presence of two persons known to the bank and the depositor. Withdrawal from the account by the account holder should be permitted after proper identification every time. The person who identifies the drawer must be known to the bank and he should preferably not be a member of the bank's staff.

7. **Agents:** A banker may open an account in the name of a person who is acting as an agent of another person. The account should be considered as the personal account of an agent, and the banker has no authority to question his power to deal with the funds in the account unless it becomes obvious that he is being guilty of breach of trust.

   However, if a person is authorised to only act on behalf of the principal, the banker should see that he is properly authorised to do the acts which he claims to do. If he has been appointed by a power of attorney, the banker should carefully pursue the letter-of-attorney to confirm the powers conferred by the document on the agent. In receiving notice of the principal's death, insanity or bankruptcy, the banker must suspend all operations on the account.

8. **Joint Stock Company:** A joint stock company has been defined as an artificial person, invisible, intangible and existing only in contemplation of law. It has separate legal existence and it has a perpetual succession. The banker must satisfy himself about the following while opening an account in the name of a company:

   (a) *Memorandum of Association:* Memorandum of Association is the main document of the company, which embodies its constitution and is called the charter of the company. It gives details, especially regarding objects and capital of the company. A copy of this document should be insisted upon while opening an account.

   (b) *Articles of Association:* The Articles of Association contain the rules and regulations of the company regarding its internal management. It contains in detail all matters which are concerned with the conduct of day-to-day business of the company. The Articles of Association is also another document that a banker insists upon. It enables the banker to know the details of company's borrowing

powers quantum, persons authorised to borrow etc. This will also enable the banker to understand whether the acts of the officers are within the orbit of the Company's Memorandum and Articles.

(c) *Certificate of Incorporation:* This is another vital document the banker has to verify and insist upon receiving a copy. This document signifies that the company can commence its business activities as soon as it gets this certificate which is not the case with a public company.

(d) *Certificate to Commence Business:* Only for public companies, the banker insists upon this document for verification. This document gives the clearance to public companies to commence their business activities. A company can borrow funds provided it has obtained this certificate.

(e) *Application Form and Copy of the Board's Resolution:* A copy of the prescribed application form duly completed in all respects has to be submitted in the beginning and that too duly signed by the company's authorised officers. Along with this, a copy of the resolution passed at the meeting of the board regarding appointment of company's bankers is quite necessary to make every thing lawful. The resolution copy should be signed by the company's Chairman and Secretary in addition, a copy of the specimen signatures of the officers empowered to operate the bank account has to be furnished.

(f) *A Written Mandate:* This is also another document that a banker insists upon. It contains all the details regarding operation, overdrawing of the account and giving security to the bank by the officers of the company. This document is useful to the bank for opening as well as for operating the account of the company.

(g) *Registration of Charges:* Whenever a company borrows, it has to give certain assets by way of security and in case the banker accepts them as security, it has to be properly recorded in the company's books, register of charges and duly registered.

(h) *Any Change in the Company's Constitution or Offices:* Whenever there is any change in the constitution like Memorandum or in respect of company's offices, it has to be communicated in writing to the bank and it should not in any way affect the earlier contracts entered into by the company with the bank. To this effect, the bankers usually take an undertaking from the company.

9. **Clubs, Associations and Educational Institutions:** Clubs, Associations and Educational Institutions are non-trading institutions interested in serving noble causes of education, sports etc. The banker should observe the following precautions in dealing with them:

(a) *Incorporation:* A sports club, an association or an educational institution must be registered or incorporated according to the Indian Companies Act, 1956, or the Co-operative Societies Acts. If it is not registered, the organisation will not have any legal existence and it has no right to contact with the outside parties.

(b) *Rules and by-laws of the Organisation:* A registered association or organisation is governed by the provisions of the Act under which it has been registered. It may have its own Constitution, Charter or Memorandum of Association and rules and by-laws, etc., to carry on its activities. A copy of the same should be furnished by the organisation to the banker to acquaint the latter with the powers and functions of the persons managing its affairs. The banker should ensure that these rules are observed by the persons responsible for managing the organisation.

(c) *A Copy of Resolution of Managing Committee:* For opening a bank account, the managing committee of the organisation must pass a resolution—

(i) appointing the bank concerned as the banker of the organisation.

(ii) mentioning the name/names of the person or persons, who are authorised to operate the account.

(iii) giving any other directions for the operation of the said account.

A copy of the resolution must be obtained by the bank for its own record.

(d) *An Application Form:* An application form duly completed in all respects along with specimen signatures of the office bearers of the institution is quite essential for operation of the account.

(e) *A Written Mandate:* It is an important document which contains specific instructions given to the banker regarding operations, over drawing etc.

(f) *Transfer of Funds:* All funds and cheques which are in the name of the Institution should be invariably credited to the Institution account and not to the personal or private accounts of the office bearers of the institution.

(g) *Death or Resignation:* In case the person authorised to operate the account on behalf of a organisation or association dies or resigns, the banker should stop the operations of the organisation's account till the organisation nominates another person to operate its account.

10. **Partnership Firm:** A partnership is not regarded as an entity separate from the partners. The Indian Partnership Act, 1932, defines partnership as the "relation between persons who have agreed to share the profits of the business, carried on by all or any of them acting for all."

Partnership is formed or constituted on account of agreement between the partners and with the sole intention of earning and sharing profits in a particular ratio. Further, the business is carried on either by all the partners or some partners acting for all. The partners carry joint and several liability and the partnership does not posses any legal entity.

A banker should take the following precautions while opening an account in the name of a partnership firm:

(a) *Application Form:* A prescribed application form duly completed in all respects along with specimen signatures of the partners of firm is quite essential for operation of the account.

(b) *Partnership Deed:* The banker should, very carefully examine the partnership deed, which is the charter of the firm, to acquaint himself with the constitution and business of the firm. This will help him to know his position while advancing funds to the firm.

(c) *A Mandate:* A mandate giving specific instructions to the banker regarding operations, over-drawing etc., is quite necessary. It will enable the banker to handle the accounts according to the needs of the firm.

(d) *Transfer of Funds:* The banker has to be very careful to see that the funds belonging to the firm should not be credited to the personal or private accounts of the partners.

(e) *Sanctioning of Overdraft:* While sanctioning funds by way of overdraft, the banker has to check up the partnership deed and examine the borrowing powers of the partners empowered to borrow and he can even ask for the financial statements of the previous years for information and perusal.

11. **Joint Accounts:** When two or more persons open an account jointly, it is called a joint account. The banker should take the following precautions in opening and dealing with a joint account:

(a) The application for opening a joint account must be signed by all the persons intending to open a joint account.

(b) A mandate containing name or names of persons authorised to operate an account.

(c) The full name of the account must be given in all the documents furnished to the banker, even if the account is to be operated upon by one or a few of the joint account holders.

(d) Banker must stop operating an account as soon as a notice of death, insolvency, insanity etc., of any one account holder is received.

(e) The joint account holder, who is authorised to operate the joint account, himself alone cannot appoint an agent or attorney to operate the account on his behalf. Such attorney or agent may be appointed with the consent of all the joint account holders.

(f) If all the persons are operating the account, then banker must see that any cheque drawn on him is duly signed by all.

(g) Banker must stop making payments as soon as letter of revocation is obtained.

(h) Banker must see that no loan or overdraft is granted without proper security.

12. **Joint Hindu Family:** Joint Hindu family is an undivided Hindu family which comprises of all male members descended from a common ancestor. They may be sons, grand sons and great grand sons, their wives and unmarried daughters. "A joint, Hindu family is a family which consists of more than one male member, possesses ancestral property and carries on family business." Therefore, joint Hindu family is a legal institution. It is managed and represented in its dealings and transactions

with others by the Kartha who is the head of the family. Other members of the family do not have this right to manage unless a particular member is given certain rights and responsibilities with common consent of the Kartha.

The banker has to exercise greater care in dealing with this account.

(a) He must get complete information about the joint Hindu family including the names of major and minor coparceners and get a declaration from the Kartha to this effect along with specimen signatures and signatures of all coparceners.
(b) The account should be opened either in the personal name of the Kartha or in the name of the family business.
(c) The documents should be signed by the Kartha and major coparceners.
(d) The account should be operated on only by the Kartha and the authorised major coparceners.
(e) While making advances, the banker should ascertain the purpose for which the loan is obtained and whether the loan is really needed by the joint Hindu family for business.

13. **Trustees:** According to the Indian Trusts Act, 1882, "a trust is an obligation annexed to the ownership of property and arising out of a confidence reposed in an accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner." As per this definition, a trustee is a person in whom the author or settlor reposes confidence and entrusts the management of his property for the benefit of a person or an organisation who is called beneficiary. A trust is usually formed by means of document called the "Trust Deed." While opening an account in the names of persons in their capacity as trustees the banker should take the following precautions:

(a) The banker should thoroughly examine the trust deed appointing the applicants as the trustees.
(b) A trust deed which states the powers and functions of trustees must be obtained by the banker.
(c) In case of two or more trustees, the banker should ask for clear instructions regarding the person or persons who shall operate the account.
(d) In case of death or retirement of one or more trustees, banker must see the provision of the trust deed.
(e) The banker should not allow the transfer of funds from trust account to the personal account of trustee.
(f) The banker should take all possible precautions to safeguard the interest of the beneficiaries of a trust, failing which he shall be liable to compensate the latter for any fraud on the part of the trustee.
(g) The insolvency of a trustee does not affect the trust property and the creditors of the trustee cannot recover their claims from trust property.
(h) A copy of the resolution passed in the meeting of trustees open the account should be obtained.

The Banker-Customer Relationship

The relationship between the banker and the customer arises out of the contract entered in between them. This contract is created by mutual consent. A contract that exists between a bank and its customer is a loan contract. This is because if the customers account is in credit, the bank owes him that money and vice versa, if the account is overdrawn. This contractual relationship between banker and customer is regulated by the rules contained in the Negotiable Instruments Act, 1881 and the Indian Contract Act, 1872. The relationship between the banker and the customer is vital. The relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account. This relationship is of two types:

A. General relationship, and B. Special relationship.

A. General relationship:

The general relationship between banker and customer can be classified into two types, viz.,

1. Primary relationship, and
2. Secondary relationship.

These are discussed below.

1. Primary Relationship

Primary relationship is in the form of a 'Debtor' which arises out of a contract between the banker and customer. Banker is neither a bailee nor a trustee nor an agent but only a debtor. Thus, the fundamental relationship is that of "Debtor and Creditor." Sometime the banker discharges agency functions like collection of bills, cheques etc., acts as a bailee by keeping valuables in safe custody and acts as trustee by administering the property for the benefit of defined beneficiary. Here the relationship is not that of 'Debtor and Creditor'. The authorities on banking law and many court decisions have said that primary relationship is that of 'Debtor and Creditor'.

Relation of Debtor and Creditor

The true relationship between a banker and his customer is that of a debtor and a creditor. Sir John Paget says: "The relation of banker and customer is primarily that of a debtor and creditor, the respective positions being determined by the existing state of the account. Instead of money being set apart in the safe room, it is replaced by a debt due from the banker. The money deposited with him becomes his property and is absolutely at his disposal." As long as the customer's account shows a credit balance, the banker would be a debtor and in case the customer's account shows a debit balance, the banker would be creditor.

In the case of Joachimson Vs Swiss Banking Corporation, it was held that "the banker undertakes to receive money and collect bills for its customer's account and that money so received is not held in trust for the customer but borrowed from him with a promise to repay it or any part of it."

Even in Indian courts similar opinion is given. By perusing these court decisions and sayings of the authorities on the subject, it is clear that the relationship that exists between the banker and customer is primarily that of debtor and creditor. The mere fact that the banker invites deposits and is prepared to pay interest, and on this condition, the customer deposits his savings, is a clear indication that the customer object to non-payment of interest by the banker so long as the banker is ready and willing to return the deposits, through a legal tender, when demanded in the proper form.

1. **The Creditor must Demand Payment:** Although the banker is a debtor and the customer is creditor, it is not at all necessary for the debtor to go to the creditor to pay the amount. This is normally expected in case of commercial transactions where in there are two parties one a debtor and the other a creditor i.e., ordinary debtor-creditor relationship. But, here in case of banker and customer relationship, though the banker is a debtor, he is not expected to approach the creditor for settlement of dues. Here, the relationship is different and has a special feature, namely, demand is necessary from the customer.

   Case : Joachimson Vs Swiss Banking Corporation 1921 - It was held that in case of debt due from a bank, an express demand for repayment by the customer is necessary before the debt becomes "actually and accruing due." In case the banker pays the amount on his own accord, he would be indirectly closing the customer's account.
2. **Proper Place and Time of Demand:** The demand by the creditor must be made at the proper place and in proper time. It means that the customer should present the cheque for payment at that place of the bank where the customer's account is maintained. It is quite clear that at other places, the customer of the state of his account are not known. It is also essential that the customers should demand payment on a working day i.e., not on a holiday or a day which is closed for public. And in addition, it must be presented during business hours i.e., it should not be presented either before or after the business hours.
3. **Demand Must be Made in Proper Form:** The demand made by the customer must be in the prescribed form as required by the bank. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the bankers. Otherwise the banker has every right to refuse payment.

   So far we have discussed the primary relationship between the banker and the customer. There are other types of relationship called secondary relationship.

2. Secondary Relationship

It will be in the form of:

(a) Banker as agent
(b) Banker as trustee
(c) Banker as bailee

Let us analyse these three aspects.

(a) *Banker as Agent:* A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. These are as follows:
   (1) Purchasing or selling of securities.
   (2) Collection of income
   (3) Making periodical payments as instructed by his customers.
   (4) Collecting interest and dividend on securities lodged by his customers.
   (5) Receiving safe custody valuables and securities lodged by his customers.
   (6) Collecting cheques, hundies, drafts of the customers.

In this case, the banker and customer relationship is, in the form of an 'Agent' and 'Principal'.

(b) *Banker as Trustee:* Ordinarily, a banker is a debtor of his customer in respect of the deposits made by the latter, but in certain circumstances he acts as a trustee also. The customer may request the banker to keep his valuables in safe vaults or one may deposit some amount and can request the bank to manage that fund for a specific purpose, which the bank does, or in case of corporate debentures, the bank can become trustee for debenture holders or the bank collects the cheques, hundies of the customers in the capacity of trustee. Thus, there are wide varieties of trustee functions discharged by the banker.

(c) *Banker as Bailee:* Section 2 of the Indian Contract Act defines that bailment as 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.

As a bailee, the banker should protect the valuables in his custody with reasonable care. If the customer suffered any loss due to the negligence of the banker in protecting the valuables, banker is liable to pay such loss. If any loss is incurred due to the situation beyond the control of the banker, he is not liable for penalty.

To conclude, the primary general relationship exists when the account is opened by customer with bank. The relationship is that of debtor and creditor. When the bank acts as trustee or agent or bailee for the valuables, he will be establishing the secondary general relationship.

B. ***Special relationship***

The special relationship between banker and customer takes the form of rights which the banker can exercise and the obligations which he owes to his customers.

Following are the rights enjoyed by the banker with regard to the customer's account:

1. Right of general lien
2. Right of set-off
3. Right to appropriate payments
4. Right to charge interest, incidental charges
5. Right not to produce books of accounts
6. Right under Garnishi order
7. Right to close accounts

Some of these rights are discussed below.

1. **Right of General Lien:** One of the important rights enjoyed by a banker is that of general lien. A lien may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property. In case lien is exercised by a trader on his customer's goods, he has no right to use the goods nor any right to sell them. All that he can do is to retain the goods until the obligations are cleared. Once the obligations are cleared by the customer, it is an obligation on the part of the trader to return back his goods immediately. There are two kinds of lien:

   (a) **Particular lien, and** (b) **General lien.**

   (a) *Particular Lien:* A particular lien confers a right to retain the goods in respect of a particular debt involved in connection with a particular transaction. This lien is enjoyed by the persons who have spent their labour on such properties and have not yet recovered their labour charges or service charges from the debtors. For example, a tailor has the right to retain the cloths made by him for his customer until his tailoring charges are paid by the customer. So is the case with public carriers and the repair shops.

   (b) *General Lien:* A general lien confers a right to retain goods not only in respect of debts incurred in connection with a particular transaction but also in respect of any general balance arising out of the general dealing between the two parties. This right can be exercised only by persons such as bankers, factors, policy brokers, wharfingers, attorneys of High Court, etc. The basic object of general lien is to have protection for the bank funds. The loans or advances granted to customers can be recovered easily if the general lien is exercised by the bankers.

   Banker's lien is a general lien. It has been held in Brandao Vs Barnett (1864, 3, CB 519) that bankers have general lien on all securities deposited with them as bankers by a customer, unless there be an express contract or circumstances that show an implied contract, inconsistent with the lien.

   Further, in the same judgement, a banker's lien has been defined as an implied pledge. Pledge is superior and strengthens the hands of the person who exercises the pledge. In case of pledge, not only the goods will come into the possession of the pledge but in addition, if default is made in complying with the terms

of the pledge, the pledgee after giving reasonable notice, can definitely auction the property pledged, recover the proceeds and appropriate the same towards his outstanding arrears. It is because of this reason pledge is said to be much superior and more powerful than lien. But in case of bankers, whenever they exercise their power of lien, it has the effect of pledge. Therefore, it is rightly said that the banker's lien is an implied pledge.

The banker can exercise his power of lien in respect of the following:

(a) Bonds and coupons belonging to the customer deposited for collection.
(b) Customer's securities leftover with the banker after paying the loan.
(c) Any security given by the customer for the purpose of a covering loan.

The banker cannot exercise his power of lien in respect of the following:

(a) Contents of safe deposit lockers belonging to the customer.
(b) Securities and money deposited for specific purpose.
(c) In respect of trust accounts wherein his customer (on whom the banker desires to put up his lien) is acting in the capacity of trustee.
(d) Amounts not due.
(e) In respect of joint accounts wherein one of the joint account holder is a customer on whom the banker desires to exercise his lien.
(f) Documents etc., submitted for getting a loan.
(g) A general lien cannot arise in respect of property of a customer pledged as security for a particular debt.
(h) No lien arises over properties on which the customer has no title.
(i) The banker cannot exercise lien when credit and liability are not in the same rights.
(j) The banker's lien is not affected by the Limitation Act.

2. **Right of Set-off:** The right of set-off is a statutory right which enables a debtor to take into account a debt owed to him by a creditor, before the latter could recover the debt due to him from the debtor. In other words, the mutual claims of debtor and creditor are adjusted together and only the remainder amount is payable by the debtor. A banker, like other debtors, possesses this right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one account with the credit balance in the other. For example, Swaroop has taken an overdraft from his banker to the extent of Rs. 10,000 and he has a credit balance of Rs. 5,000 in his savings bank account, the banker can combine both of these accounts and claim the remainder amount of Rs. 5,000 only. This right of set-off can be exercised by the banker if there is no agreement - express or implied contrary to this right and after a notice is served on the customer intimating the latter about the former's intention to exercise the right of set-off. To be on the safer

side the banker takes a letter of set-off from the customer authorising the banker to exercise the right of set-off without giving him any notice.

There are conflicting decisions regarding the application of right of set-off.

In the case of Garnett Vs Mckean (1872, 27, L.T. 560), it was held that in the absence of any special agreement to the contrary, a banker might set-off a customer's credit balance against a debt due to him from the customer and that there was no legal obligation on a bank to give notice to a customer of his intention to combine accounts. But in another subsequent case Greenhalgh and Sons Vs Union Bank of Manchester (1924, 2, K.B. 153), the Learned Judge observed: "If the banker agrees with his customer to open two accounts or more; he has not in my opinion, without the assent of the customer, any right to move either assets or liabilities from one account to the other; the very basis of his agreement with his customer is that the two accounts shall be kept separate."

In view of these conflicting opinions, the banker can be on the safer side by taking an agreement from the customer authorising him to combine the accounts at any time without notice and to return cheques which, as a result of his having taken such action, would overdraw the combined account. However, in such cases as the death or bankruptcy of the customer, the banker can exercise the right of set-off without notice even in the absence of an agreement, in order to ascertain the net amount owing to him.

Conditions Necessary for Exercising the Right of Set-off

The right of set-off can be exercised subject to the fulfillment of the following conditions:

(a) The accounts must be in the same name and in the same right.
(b) By giving notice to customer of banker's intention to combine accounts.
(c) The right can be exercised in respect of debts due and not in respect of future debts or contingent debts.
(d) The amount of debts must be certain.
(e) If there is letter of set-off given by customer.
(f) If the accounts are of dissimilar nature.
(g) The right may be exercised in the absence of an agreement to the contrary.
(h) The banker has the right to exercise this right before the Garnishee order is made effective.

Conditions Under which the Right Cannot be Exercised

(a) If the accounts are not in the same right.
(b) The right of set off cannot be extended to a future contingent debt e.g., a bill which will mature in future.
(c) If the amounts of debts are uncertain.
(d) Trust account in which personal account of the customer cannot be combined.
(e) The account balance of an individual cannot be set-off against a joint account balance in which he is one of the account holders.

Automatic Right of Set-off

The banker enjoys the right of Automatic set-off in following cases:

(a) On the death, insolvency or insanity of customer.
(b) On the insolvency of a partner.
(c) On receipt of Garnishee order
(d) On receiving the notice of assignment of a customer's credit balance.
(e) On receiving the notice of second mortgage on the security on which the bank holds first charge.
(f) On the winding up of a company.

Thus, the right of set-off a statutory right. But to exercise this right, it is the normal practice of the banker to obtain a letter of set-off from the customer.

3. **Right to Appropriate Payments:** Whenever the customer deposits funds into his account in the bank, it is his duty to inform the bank to which account they are to be credited (provided the customer has more than one account at the same bank). Once the customer gives specific directions regarding appropriation, the banker has no right to alter them. It is his bounden duty to carry out the instructions of the customer. This right of appropriation is to be exercised by the customer at the time of depositing funds and not later. In case the customer is silent or fails to give instructions, the banker has every right to appropriate in his own way. In case both have not used their powers, the rule given in Clayton's case would be applicable. In this famous case (Davayness Vs Noble, 1816, 1-Merivale 529, 572), the verdict given by the court was as follows: The first item on the debit side is reduced by the first item on the credit side.

   Certain conditions have to be fulfilled to apply the rule in Clayton's case. They are:

   (a) This rule cannot be applied to the accounts which were stopped in the middle and revived after certain date.
   (b) The rule is not applicable to broken accounts.
   (c) If two separate accounts are maintained the rule is not applicable.
   (d) Contrary intentions should not be evidenced by the parties concerned.

4. **Right to Charge Interest:** As a creditor, a banker has the implied right to charge interest on the advances granted to the customer. The rate of interest is nowadays levied as per the directions of Reserve Bank of India. It is charged on half yearly or quarterly basis and generally compound interest is used. The interest is directly debited, i.e., charged to the customer's account and then the interest is calculated on the principal with interest. Interest may also be fixed by the banker and customer by mutual consent. It may not however be beyond the prescribed limits of Reserve Bank of India. In Konakalla Venkata Satyanarayana and others Vs State Bank of India (AIR, 1975 A.P. 113) the agreement provided

that "interest @..... shall be calculated on the daily balance of such account and shall be charged to such account on the last working day of each month." For several years the customer availed the overdraft facilities and periodical statements of accounts were being sent to the customer showing that interest was being changed and debited at compound rate and no objection was raised at any time. The High Court, therefore, held that there was no doubt that the customer had agreed to the compound rate of interest being charged and debited to their account. Banks also charge incidental charges on the current accounts to meet the incidental expenses on such accounts.

5. **Right not to Produce Books of Accounts:** According to the provisions of the Bankers Book Evidence Act, the banker need not produce the original books of accounts as an evidence in the cases in which the banker is not a party. He can issue only an attested copy of the required portion of the account which can be utilised as an evidence before the court. When the court is not satisfied with the certified copy, the court can summon the original books. But when a banker is a party to the suit, the court can force the banker to produce the original records in support of his claim.

6. **Right under Garnishee Order:** The term "Garnishee" is derived from the Latin word "garnire" which means "to warn." This order warns the holder of money of judgement debtor, not to make any payment out of it till the court directs.

   It is an order issued by a competent court of law addressed to a banker instructing him to stop or withhold payment of money belonging to a particular person who has committed a default in satisfying the claim of his creditors. Therefore, whenever a bank receives such an order, the banker has to obey the order fully. Let us take an example to clearly explain this procedure.

   Chaluvaiah is a contractor and obtains a loan from Eshwarappa a money lender or banker. Chaluvaiah fails to pay the money to Eshwarappa as per the stipulation. Hence Eshwarappa files a suit in the court of law for dues. Eshwarappa also knows that the money is due to Chaluvaiah from the agency (third party) with which he is doing his contract business. Now Eshwarappa can request the court to issue an order directing the Chaluvaiah's agency not to make any payment to Chaluvaiah. If the court issues the order that becomes a garnishee order. In this suit Chaluvaiah is judgement debtor and Eshwarappa is a judgement creditor. The third party is garnishee.

   Sheldon defines Garnishee order thus, "It is an order obtained by a judgement creditor attaching funds in the hands of a third party, who owes the judgement debtor money, warning the third party, not to release the money attached until directed by court to do so."

   Thus, garnishee order is a direction given by the court to a third party who is due to the judgement debtor not to make any payment till it gives a verdict regarding the paid money. This order is issued at the request of the judgement creditor.

The Garnishee order is issued in two parts.

A. *Order-Nisi:* It is an order issued by a court on a specific banker ordering him, not to release any funds belonging to a particular customer (judgement debtor) until further orders are issued. In the meantime, the judgement debtor is requested to appear before the court for further proceedings.

B. *Order-Absolute:* This is an order of the court issued to a banker after completion of the hearing of the parties concerned and through this order, the court specifies how much amount is to be kept separate. The banker has to follow these orders after looking at the position of the customer's account.

In the following circumstances the Garnishee order would not be applicable:

(a) Where the account of the judgement debtor is a joint account holder with another person;
(b) Where the identity of the judgement debtor is doubtful;
(c) Where the account of the judgement debtor is held by him in the capacity of a trustee;
(d) Where the judgement debtor has previously made an official assignment of his balance in favour of a third party and the banker is informed about it in writing;
(e) Where the account of the judgement debtor reveals a debit balance.

7. **Right to Close Accounts:** Banker also enjoys the right to close his customer's account and discontinue operations. This process terminates the relationship between banker and customer. This is done only in situations where the continuation of relationship seems unprofitable to the banker.

These are the rights enjoyed by the banker with regard to the customer's account.

Obligations of Bankers

Bankers are under the obligations to fulfil certain duties while dealing with customers. Such obligations are as under:

1. Obligation to honour the customer's cheques.
2. Obligation to maintain secrecy of customer's account.
3. Obligation to receive the cheques and other instruments for collection.
4. Obligation to honour the cheques of customers across the counter.
5. Obligation to give reasonable notice before closing the customer's accounts.

Some of these obligations are discussed below.

1. Obligation to Honour the Customer's Cheques

Section 31 of the Negotiable Instruments Act, 1881, imposes a statutory obligation upon the banker to honour the cheques of his customer drawn against his current account so long as his balance is sufficient to allow the banker to do so, provided the cheques are presented within a reasonable time after their ostensible date of issue. The section runs as follows:

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

This provision clearly indicates that the banker should honour the customers demand for payment by cheque on certain conditions which are stated below.

(a) *Sufficient Balance:* There must be sufficient funds in the account of the drawer. The cheques sent for collection by the customer are not treated as cash in the hands of the banker until the same are realised. The banker credits the amount of such cheques to the account of the customer on their realisation. If the customer draws a cheque on the unrealised amounts, the banker is justified in dishonouring the cheque with the remark "effects not cleared."

(b) *Application of the Funds:* The funds must be capable of being properly applied to the payment of customer's cheque. This means, the funds maintained for a specific purpose or trust funds or the funds assigned in the name of some other person cannot be applied for honouring the cheques. Thus, the funds so sought by the customer by cheque should be unencumbered and must be capable of being properly applied.

(c) *Duly Required to Pay:* The banker is bound to honour the cheques only when he is duly required to pay. This means that the cheque, is complete and in order, must be presented before the banker at the proper time. Ordinarily a period of six months is considered sufficient within which a cheque must be presented for payment. On the expiry of this period the cheque is treated as state and the banker dishonours the cheque. Similarly, a post-dated cheque is also dishonoured by the banker because the order of the drawer becomes effective only on the date given in the cheque.

(d) The instrument used for drawing the amount should be properly written and fulfil and legal obligations.

(e) The banker should have reasonable time to collect the bill or cheque.

(f) There should not be any legal restriction to pass the cheque for payment say in case of Garnishee order, restriction is imposed in the account.

(g) The banker need not honour the cheques presented against domiciled bills.

Thus, the banker should be very careful while honouring a cheque drawn by a customer.

Consequences of Wrongful Dishonour of Cheque

A cheque may be dishonured by a banker by mistake or by negligence on the part of any of his employees. Even though there is sufficient balance, and the cheque has been drawn in a proper manner. The banker will be held responsible for wrongful dishonour of a cheque because of loss or damage to the customer. The phrase "Loss or damage" in Section 31 of the Negotiable Instruments Act, 1881 includes (a) The monetary loss suffered by the

customer, and (b) The loss of credit or reputation in the market. Thus, the banker is liable to compensate the drawer not only for the actual monetary loss suffered by him, but also for the injury top or loss of his reputation, as a result of dishonour of a cheque.

In case the customer happens to be a trader, the loss would be substantial damages. In case the customer is a non-trader, the banker would be liable only for normal damages {(Case: Robin Vs Steward (1854) 146 - B 595) (Case: Gibbs Vs Westminister Bank (1939) 2 K.B. 882)}. In the case of Sterling Vs Barclay's Bank Ltd., where the banker had made a mistake in wrongfully dishonouring the customer's cheque, the customer was not entitled to substantial damages but reasonable damages as the customer had two cheques dishonoured earlier and further, people in that trade did not think much of cheques being dishonoured as they just carried on their living with bare necessaries. (Case: Davidson Vs Barday's Bank Ltd., 1940 AII. E.R. 316). The customer had issued a cheque for £ 2-15-8 and it was dishonoured and the matter was referred to the court and the court ordered that substantial damages to the tune of £ 250 should be paid.

2. Obligation to Maintain Secrecy of Customer's Account

In every profession, there are certain things to be maintained absolutely in secret; for example, a doctor is not expected to disclose the details of his patients to others. The profession demands from him that he must maintain those matters in strict confidence. Similarly, a bank's profession also demands that he should maintain the particulars of his customer's accounts in secret.

The banker has an implied obligation to maintain secrecy of the customers account. He should not disclose matters relating to the customer's financial position since it may adversely affect the customer's credit and business. This obligation continues even after the account of the customer is closed.

Only in the following circumstances, disclosure is justified:

(a) *To Satisfy Statutory Requirements:* According to the Income Tax Act, the banker is required to give out information regarding his customers to the Income Tax Department. Similarly, whenever the court needs any information regarding the customers, the banker is required to give the information. According to the Banking Regulation Act, all banks are required to give in the prescribed forms detailed information regarding the customers to the Reserve Bank of India.

(b) *As a Common Courtesy:* In this case, it is a common practice followed among bankers to exchange information regarding their customers, accounts etc., as a matter of common courtesy. Whenever the banker is called upon to give information regarding his customers, he can do so without any difficulty. As far as possible, he should furnish bare facts while expressing his opinion. He should be very careful while expressing his opinion. He should not exaggerate nor underestimate the financial standing of his customers.

(c) *Disclosure at the will of Customer:* The banker can disclose the state of affairs of the customer's account when the customer gives his consent to disclose the accounts. The auditor of the organisation can fully examine the customer's account when an express consent is given by him. Similarly when a customer gives the name of a guarantor, the guarantor can examine the accounts of the customer which the banker should furnish. When banker acts as a reference, he can disclose the accounts of the customer.

(d) *To Protect his Own Interest:* Whenever the banker is required to protect his own interest, if he discloses the details of a customer's account, it must be a reasonable and proper occasion. For example, if the banker is to recover his own money from a particular customer, he may give the details to his lawyers.

(e) *To Protect Public Interest:* The Banking Commission (1972) opined as follows: When banks are required to give out information regarding their customers in the interest of the public, the information should relate to financial aspect of the customers. The following are instances of such cases:

(i) Where considerable amounts are received from other countries.

(ii) In case the bank thinks that the customer is carrying on such activities which are not congenial in the interest of the nation.

(iii) In case the banker thinks that the customer is trying to break the provisions of the law on the basis of his records.

(iv) When the Government calls upon the bank to give information regarding a particular customer and when the bank feels that a particular customer has committed an offence.

3. Obligation to Receive Cheques and Other Instruments for Collection

Basically, the business of banking, as it is known today, comprises acceptance of money on deposit account and payment of cheques. It also includes collection of cheques. It may rightly be contended that anyone who does not perform these essential services is not a banker. Whenever a banker is entrusted with the job of collection of cheques, they must be collected as speedily as possible through the accepted channels. Failure to exercise proper care and employ the recognised route for collection may make the bank liable for any loss which the customer may sustain.

4. Obligation to Give Reasonable Notice before Closing the Account

According to law, a debtor and a creditor may terminate the relationship without notice – by the debtor paying off the balance or the creditor recalling the debt. It is not so simple between a banker and a customer for the obvious reason that the banker is under an obligation to honour his customer's cheques. If this obligation could be terminated by the banker without notice, the customer might be faced with an embarrassing situation. Reasonable time must be granted to enable him to make alternative arrangements. Where any customer becomes a nuisance through overdrawing without arrangement or issuing post-dated cheques etc., it is advisable to close his account. But reasonable time has to be given to enable him to make

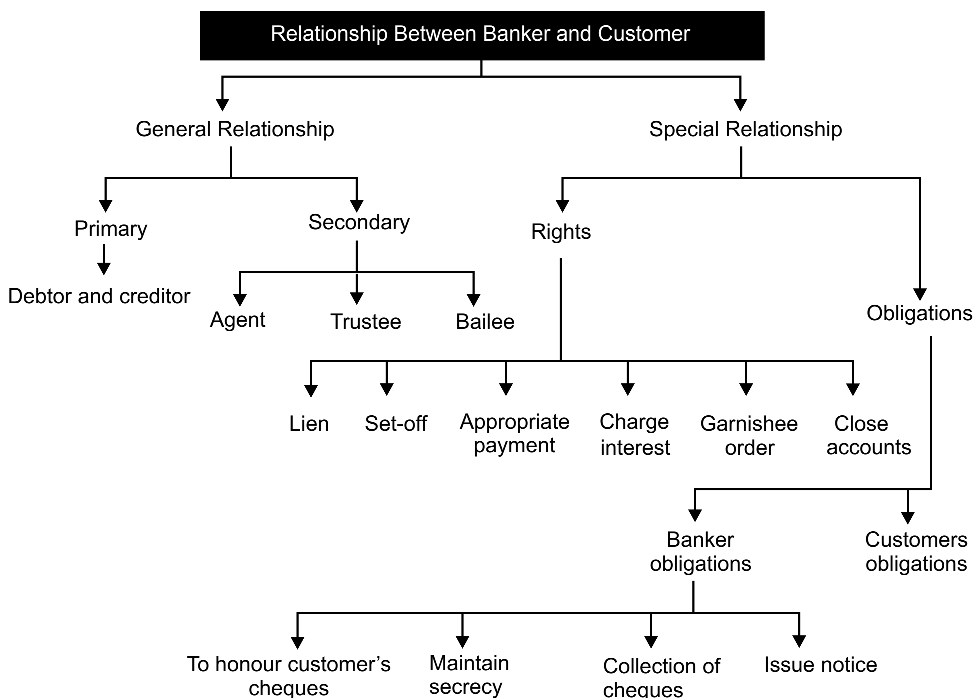
alternative arrangements if he so desires. If a bank abruptly closes the customers account, it might affect his credit, giving cause for an action against the bank for damages.

Obligations of Customers

Customers are under the obligations to fulfil certain duties while dealing with banks. Such obligations are as under:

(a) Not to draw cheques without sufficient balance.
(b) To draw cheques in such a manner so as to avoid any change of alternation.
(c) To pay reasonable charges for services rendered.
(d) To make a demand on the banker for repayment of deposit.

So far we have discussed the primary and special relationship between the banker and the customer. This relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account. The relationship stands established as soon as the agreement or contract is entered into. This relationship is shown in the following chart.



Conclusion

To conclude, it is rightly said that the relationship between a banker and its customer is that of a bailee and bailor. As a bailee, the banker is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take of his

own goods of the same bulk, quality and value as the goods bailed. However, in the absence of any special contract, the bailee gets protection and is not held responsible for the loss, distruction or deterioration of the thing bailed, if he has taken the amount of care of it.

Questions for Discussion

1. Discuss the types of relationship between the banker and the customer.
2. Discuss the special features of relationship between the banker and the customer.
3. What do you mean by a Banker's Lien? Explain the distinction between General Lien and Particular Lien. What are the special features of Banker's Lien?
4. Discuss a banker's right of set-off and right of appropriation.
5. What is a Garnishee order? What are the main effects of Garnishee order?

9

OPENING AND OPERATING BANK ACCOUNTS

INTRODUCTION

The most important function of a bank is to accept deposits from the public. Customers deposit their savings for safety and earning interest. A bank provides facilities to open various types of accounts keeping in mind the needs of its customers. Generally, the bank accounts are classified into three categories: (a) the current accounts, (b) the fixed deposit accounts, and (c) the saving deposit accounts. In recent years, a few new types of accounts have also been introduced by banks. Prominent among them are, the recurring deposit accounts, students deposit accounts, multi-purpose deposit scheme, super savings scheme, janata deposit scheme, pigmy deposit scheme, loan linked deposits etc. Some banks also issue 'cash certificates' to solicit deposits for a fixed period. It is important to point out that the rates of interest offered by different banks under different schemes do not vary much because these are governed by the directives from the Reserve Bank of India. No bank is allowed to pay higher rate of interest under any scheme as is prescribed by the Reserve Bank. The rates are prescribed by the Reserve Bank taking into consideration the period of deposits.

Types of Accounts

The bank accounts are classified into three categories. These are as follows:

1. **Current Account:** A Current Account or Demand Deposit Account is a running and active account which may be opened with a bank by a businessman or an organisation by making an initial deposit of Rs. 300 in rural areas and Rs. 500 in urban areas. This account may also be operated upon any number of times during a working day. This account never becomes time barred, because no interest is paid for credit balance in this account.

Before opening a current account, banks are required to obtain references from respectable parties, preferably those of a current account-holder. In case, a person or a party opens an account with the bank without satisfactory references, the banker would be inviting unpleasant results.

By accepting deposits on a current account, the banker under takes to honour his customer's cheques so long as there is enough money to the credit of the customer. In case of current account, there is no limit on the amount or number of withdrawals. Under Section 129 of the Negotiable Instruments Act, 1881, the banker may have to suffer loss if he pays a forged cheque contrary to the instructions given by the customer.

Benefits of Current Accounts

The customers derive the following advantages from current accounts:

(a) Demand deposits are treated at par with cash. They constitute cheque currency. Cheques are readily accepted in business for making and receiving payments.

(b) Businessmen have to receive and make a large number of payments every day. It is difficult to handle cash. The cheque facility removes the difficulty.

(c) There are no restrictions on the number of cheques or on the amount to be drawn at a time by one cheque.

(d) Overdraft facilities are allowed by the banks to the current account holders.

2. **Savings Bank Account:** Savings deposit account is meant for small businessmen and individuals who wish to save a little out of their current incomes to safeguard their future and also to earn some interest on their savings. A savings account can be opened with as a small sum of Rs. 500. A minimum balance of Rs. 500 is to be maintained in the account if cheque book facility is not required. However, if a cheque book has been issued, a minimum balance of Rs. 1000 is necessary.

   There are restrictions on the maximum amount that can be deposited in this account and also on the withdrawals from this account. The bank may not permit more than one or two withdrawals during a week and may lay down a limit on the amount that can be withdrawn at one time.

   Savings account holders are allowed to deposit cheques, drafts, dividend warrants, etc., which stand in their name only. For this facility, it is necessary that account holder must be introduced by a person having a current or savings account in the same bank. However, the banks do not accept cheques or instruments payable to third party for deposit in the savings bank account. Banks allow interest on deposits maintained in savings accounts according to the rates prescribed by the Reserve Bank of India.

Popularity of Savings Accounts

Savings bank accounts is very popular among the general public because of the following advantages:

(a) A savings account can be opened with as little as Rs. 500 only. It helps the people of small means to save for their future.
(b) The balance lying in the savings bank earns some interest. The customer is benefitted as his money grows with the bank.
(c) The money lying with the bank is quite safe. There is no fear of theft.
(d) The money can be withdrawn conveniently from the savings account.
(e) The customer gets the cheque book facility if his account is duly introduced by another account-holder and he keeps a minimum balance of Rs. 1000. It is quite easy to make payment to third parties by issuing cheques.

3. **Fixed Deposit Account:** Money in this account is accepted for a fixed period, say one, two or five years. The money so deposited cannot be withdrawn before the expiry of the fixed period. The rate of interest on this account is higher than that on other accounts. The longer the period, the higher is the rate of interest. Fixed deposits are also called "time deposits" or "time liabilities." Fixed deposits have grown its importance and popularity in India during recent years. These deposits constitute more than half of the total bank deposits. The following are the special characteristics of fixed deposits:
   (a) *Suitability:* Fixed deposits are usually chosen by people who have surplus money and do not require it for some time. These deposit accounts are also favoured by the bankers because fixed deposit funds can be utilised by them freely till the due date of the repayment.
   (b) *Rate of Interest:* The rate of interest and other terms and conditions on which the banks accept fixed deposits are regulated by the Reserve Bank of India. The Reserve Bank of India revised the rates of interest on fixed deposits several times. Banks can use fixed deposits for the purpose of lending or investments. So they pay higher rate of interest on fixed deposits. Though interest is payable at the stipulated rate, at the maturity of the fixed deposit, banks usually pay interest quarterly or half-yearly also at the request of the depositor.
   (c) *Restrictions on Withdrawals:* Withdrawal of interest or the principal amount through cheques is not permitted. The depositor is not given a cheque book. At the request of the customer, the banker may credit the amount of interest or the principal to his saving or current account from which he may withdraw the same through cheques.
   (d) *Payment before Due Date:* Banks also permit encashment of a fixed deposit even before the due date, if the depositor so desires. But the interest agreed upon on such deposit shall be reduced.
   (e) *Advances Against Fixed Deposits:* The banker may also grant a loan to the depositor on the security of the fixed deposit receipt. Banks are now free to determine the interest rate chargeable on loan advances of over Rs. 2 lakhs.

Opening of Fixed Deposit Account

Fixed deposit account can be opened either with placement of cash or cheque. The depositor has to fill in an "Application Form" requiring the bank to accept deposit of a specified sum of money on deposit account. The application form contains the particulars of the customer, the amount proposed to be deposited, the terms of deposit etc. The specimen signatures of the customer are also to be obtained along with the application. If it is being opened by joint-parties, there should be mandate as to its discharge. A fixed deposit receipt is then issued to the depositor by the bank. The fixed deposit receipt is an acknowledgement of the receipt of the particular amount of money from the person or party named therein.

Contents of Fixed Deposit Receipt

The fixed deposit receipt issued under the seal of the bank has the following contents:

(a) Name and address of the depositor.
(b) Amount deposited, described in words and figures.
(c) The period for which the deposit is made.
(d) The rate of interest allowed on the deposit.
(e) The date of opening the deposit account.
(f) The date on which the deposit will become due for repayment.
(g) The name of the bank, place of its office accepting the deposit.
(h) The words "not transferable" appear prominently across the face of the receipt to indicate its "non-negotiable" character.
(i) Signature of the Manager or other authorised Officer of the bank.
(j) On the back of the receipt, particulars of interest accruals, and payment and repayment of deposit on maturity are recorded to be filled in from time to time.

Significance of Fixed Deposit Receipt

(1) Fixed deposit receipt is an acknowledgement of the receipt of the particular amount of money from the person or party named therein.
(2) The party described therein is entitled to receive the proceeds from the bank on maturity of the period.
(3) The depositor is also entitled to the receipt of interest at the stated rate.
(4) If the deposit receipt is lost, the depositor has to furnish an "indemnity bond" or stamped paper and thereafter a duplicate receipt may be issued by the bank.
(5) It is non-negotiable. Hence, any holder of the receipt under endorsement or delivery has no right to the proceeds of the account.
(6) It can be offered as a security for raising the loan. Usually 90% of the deposit is given as an advance at about 1% interest higher than is allowed on the deposit.
(7) It does not bear any stamp under the Stamp Act applicable to legal documents of claim.
(8) But a banker repaying the money to the depositor has to take a stamped receipt as legal acquittance of the payment. Stamped receipt is compulsory when the amount

exceeds Rs. 20. In case of renewal, simple acknowledgement of the customer is taken and a fresh application for the renewal of deposit is taken from the customer. A new deposit receipt is then issued.

4. **Recurring Deposit Account:** The Recurring Deposit Account has gained wide popularity these days. Under this, the depositor is required to deposit a fixed amount of money every month for specific period of time. Each instalment may vary from Rs. 50 to Rs. 500 or more per month and the total period of account varies from 12 months to 10 years. After the completion of the specified period, the customer gets back all his deposits along with the cumulative interest accured on them.

   Recurring deposit account offers the following benefits to the public:

   (a) It provides a good way to save in small amounts for use in the future, e.g., education of children, marriage of children, etc.

   (b) People having low income may open a recurring deposit account with a commitment to deposit as low as Rs. 100 every month.

   (c) The recurring deposit account can be opened for any period ranging from 12 months to 120 months.

   (d) Standing instructions to transfer monthly instalments from the savings account of the depositor are carried out without any charge.

   (e) Loan can be taken up to 90 % of the deposits if the depositor needs money.

Procedure of Opening Current and Savings Accounts

A bank should be very careful in entertaining a new customer. It will be taking a great risk if it opens an account of a customer without knowing the where-abouts of the latter. As said earlier, the opening of an account involves the honouring of cheques on the part of the bank so long as customer's account has credit balance. The bank will also provide a number of other services to the customer like collection of cheques, dividends, etc., and acting as agent of the customer. When the customer is not adequately known to the bank, it may result in wrong payment or encashment of forged cheques. Hence, it is essential that the bank should make through enquiry regarding the customer before opening an account with him. For this purpose, the bank may follow the procedure given below.

1. **Presenting of Application:** The applicant should fill in the prescribed form for opening of an account available in the concerned bank. Banks keep different forms for individuals, joint Hindu families, partnership firm, companies, etc. The applicant should fill in the relevant form and mention his name, occupation, full address, specimen signature and other particulars required by the bank. The applicant has also to declare that he will be bound by the bank's rules for the time being in force for the conduct of the concerned account.
2. **Introduction:** The banks follow the practice of opening the account only when the applicant is properly introduced by an existing customer of the bank. Sometimes, reference is given by the depositor and the bank may seek the opinion of the referees

regarding the integrity and financial stability of the applicant. If the bank is satisfied about the identity and standing of the applicant, it will agree to open an account. It is, however, advisable that the person introducing the applicant to the banker or acting as referee must himself be a respectable person.

The idea behind proper introduction is that the bank should entertain a person only who is honest, reliable and responsible. Such a proper enquiry will prevent fraud and overdrawal of money. The bank should take extraordinary care in accepting the introduction or reference from any person. The signature of the person introducing the applicant should preferably be obtained in the presence of some officer who should tally his signature on record and verify the same.

A question arises as to why bank should not open the account without proper introduction. The answer is that if the introduction is not taken properly, the banker will invite many risks which are as follows:

(a) The bank cannot avail itself of the statutory protection given to the collecting bank by Sec. 131 of the Negoliable Instruments Act. A collecting bank will incur no liability if it has acted in good faith and without negligence. If the bank does not make proper inquiry and does not get proper introduction, it will be held to be negligent if the customer later on turns to be an undesirable person. The bank will remain liable to the true owners of the cheques, drafts etc., if such instruments are stolen by the customer whose identity cannot be established and process are collected by the bank and withdrawn by the former.

(b) If, overdraft is created by mistake in the account of a customer who is not properly introduced, the bank will not be able to realise the money because the identity of the customer cannot be established.

(c) Undesirable customers may cause annoyance to the public by cheating them. Such a man might defraud the public by issuing cheques on his account without having adequate balance.

(d) If the bank receives deposits from an undischarged insolvent without proper introduction, it will run the risk of attachment of these deposits by the court declaring him insolvent.

3. **Specimen Signature:** The applicant is required to give his specimen signature on a card meant for this purpose. This will help to protect the bank against forgery because whenever the cheque is presented at the counter of the bank for payment the signature will be tallied with those on the card computer.

4. **Deposit Cash:** When the above formalities are completed, the bank will agree to open an account in the name of the applicant. Before opening the account, the customer must deposit the minimum initial deposit in cash as per rules framed by the Reserve Bank. In case of a savings account, a minimum deposit of Rs. 500, if no cheque book is required, or of Rs. 1000, if cheque book is required must be made. In case of current accounts, a minimum deposit of Rs. 5000, if the branch is in an urban area, or of Rs. 3000, if the branch is in any other area, must be made with the bank.

5. **Issue of Pass Book:** A pass book is issued by the bank to the customer after the account has been opened and an account number has been allocated. The pass book contains the record of transactions between the bank and the customer. It is a copy of the account of the customer in the bank's ledger as on a particular date. It is written by the bank from its records and is meant for the use of the customer. It is called a pass book because it frequently passes between the bank and the customer.

   A pass book is very important for a customer because he can know the position of his account and know certain items like interest, incidental charges, dividends collected, bills paid, etc. This will also enable him to prepare a 'Bank Reconciliation Statement'.

Forms Used in Operation of Bank Account

Operating a bank account means that the customer deposits a sum of money in near future and withdraws money from the account according to the needs. The following forms can be used for the operation of the bank account:

(1) Pay-in-slip Book.
(2) Cheque Book.
(3) Pass Book.

1. **Pay-in-slip Book:** This book contains printed slips with perforated counterfoils. The bank supplies pay-in-slip either in book form or loose to the customer while depositing cash, cheques, drafts etc., to the credit of his account. Some banks supply slips for depositing (a) Cash, and (b) Cheques/Drafts etc. It is noted that different types of forms are used for the collection of outstation cheques, bills or drafts. The depositor is expected to fill in the amount, nature of account, account number, date, details of currency notes, and coins, signature etc., in the pay-in-slip. After recovery the cash, cheque or draft, the bank puts the date-stamp and is signed by the Cashier and counter-signed by the Accountant or Manager and the counterfoil is returned to the depositor, which is used for the record of the customer.
2. **Cheque Book:** A cheque book contains bank cheque forms with counterfoils which can be used by the customer to withdraw money from his account. The cheque book and the counterfoils are serially numbered and these numbers are entered into the cheque book register of the bank and also recorded in the bank ledger.
3. **Pass Book:** A pass book is a book in which the banker keeps a full record of the customer's account. It is written by the bank, and hence it is essential for a customer to send it (pass book) periodically to the bank, so that up-to-date entries may be entered by the bank. Some banks, like American Express, Grindlays Bank send a Statement of Account periodically, i.e., fortnightly or monthly to the customer in place of pass book. (It should be noted that a Statement of Account is very popular among Current Account holders.)

   Sir John Paget expressed his views on the proper function of the bank's statement and the pass book as : ..."..............saving negligence or reckless disregard on the part of

either the banker or the customer ....to constitute a conclusive, unquestionable record of the transactions between them..............After the full opportunity of examination on the part of the customer, all entries, at least to his debit, ought to be final and not liable to be reopened later, at any rate, to the detriment of the banker."

In support of his view, he cites Devaynes Vs. Noble (1816) Case in which it was decided that on the delivery of the pass book to the customer, he "examines it and if there appears any error or omission, brings or sends it back to the bank to be rectified; or if not the silence is regarded as an admission that the entries are correct."

Closing of a Bank Account

A bank account may be closed by either party i.e., the customer and the banker. A bank account may be closed in the following cases:

1. **At the Request of the Customer:** If the customer requests the bank to close down his account, the bank has to close the account. The customer returns the unused cheques and presents his pass book. The bank closes down the account, completes the pass book and returns it to the customer after writing the words 'Account closed'.
2. **Inoperative Account:** If the customer does not operate an account for a long time (In Punjab National Bank for example, for 3 years), the bank can close down the account. However, the banker is required to give notice to the customer to withdraw his money. In case the customer is not traceable, after a reasonable effort, the amount standing to the credit of the customer is transferred to the 'Unclaimed Deposit Account' and the account is closed. In case the customer claims the amount later on, it is returned to him.
3. **At the Instance of the Banker:** The banker is also entitled to close the customer's account when the conduct of the customer is not desirable. For example, when the customer is guilty of forgery or frequently issues cheques without sufficient balance or does not repay the loans and advances etc.

   In such circumstances the banker should give a notice to the customer to close his account by a particular date. However, he should not dishonour his cheques in the mean time so long as there is balance in his account. In case the customer does not close the account within the time specified, the banker should close the account and give him a notice that his account has been closed so that he may not issue cheques to his creditors. The bank should return the credit balance standing in his account by a bank draft.
4. **On Receipt of Notice of Customer's Death:** When the bank receives notice of death of the customer, he must stop operation of the account as death of the customer terminates his authority.
5. **On the Insanity of the Customer:** When the bank receives a notice of insanity of his customer, he must stop payment from his account.

6. **On Insolvency of the Customer:** When the bank comes to know of insolvency of his customer, he must stop payment. The balance standing to the credit of the customer, he must stop payment. The balance standing to the credit of the customer is transferred to the official receiver or assignee.
7. **On Receipt of Garnishee Order:** The banker should reserve amount specified in the Garnishee Order. He may make payment of the customer's cheques out of the remaining balance, if any.
8. **On Receiving Notice of Assignment:** When the banker has received notice of assignment of the credit balance in the customer's account, he must stop payment from the account. The bank is liable to pay the balance to the assignee.

Insurance of Bank Deposit

The Bank Deposit Insurance means giving a guarantee to depositors that their deposits will be returned if the bank fails. The need for such a guarantee has arisen after the failure of several banks on account of inadequate capital, unsound banking practices etc. In India, the necessity of Deposit Insurance was felt after the failure of Palai Central Bank, a Scheduled Bank of South India.

Deposit Insurance is regarded as the most powerful competitive edge of banking industry. However, the application of the scheme in its present form has shielded the industry from market discipline. Since the depositors have no incentives to favour one bank over another, badly managed banks, even nearing insolvency, have been able to attract deposits as easily as healthy and well-run institutions. It is high time that Deposit Insurance prices the insurance cover on the basis of quality of assets rather than on uniform pricing basis. This would by itself considerably strengthen the banking industry.

Deposit Insurance and Credit Guarantee Corporation (DICGC)

The Deposit Insurance Corporation Act was passed by the Parliament in 1961 which set up the 'Deposit Insurance Corporation' with effect from January 1, 1962. It took over the undertaking of the Credit Guarantee Corporation of India Ltd., with effect from July 15, 1978. Later, by the integration of two organisations the Corporation was renamed as the Deposit Insurance and Credit Guarantee Corporation (DICGC).

Objectives

The DICGC has twin objectives of giving insurance to small depositors in banks and five credit guarantee schemes (four for small borrowers and one for small-scale industries) guaranteeing the priority sector advances granted by participating banks and financial institutions.

Credit Guarantee Function

The DICGC is operating following schemes: (1) Credit Guarantee Schemes for small borrowers, e.g., (a) Small Loans Guarantee Scheme, 1971; (b) Small Loans (Financial Corporation) Guarantee Scheme, 1971; (c) Service Co-operative Societies Guarantee Scheme, 1971;

(d) Small Loans (Co-operative Banks) Guarantee Scheme, 1984; (e) Small Loans (Co-operative Credit Societies) Guarantee Scheme, 1982; (2) Credit Guarantee Scheme for small-scale industries, 1981.

Nomination Facility

The Banking Laws (Amendment) Act, 1983, inserted a new Part III B in the Banking Regulation Act, 1949 to give effect to some of the recommendations of the Banking Commission. Newly inserted Section 45ZA and the rules framed thereunder in 1985 provide for the facility of nomination by depositors in banks as follows:

(a) A depositor may nominate, in the prescribed manner, person to whom, in the event of the death of the depositor, the amount to his credit may be paid by the banking company.

(b) In case of a joint account, all the depositors together may nominate a person to whom, in the event of death of all the joint depositors, the amount of their credit may be paid by the banking company. Thus, the nominee's right to receive deposit money arises only after the death of all the depositors. There cannot be more than one nominee in respect of a joint account.

(c) Nomination facility is available to all types of deposit accounts, including the accounts opened for credit of pension.

(d) Nomination can be made in favour of individuals only and not associations, societies, trusts or any organisation or their office-bearers.

(e) In the case of a deposit made in the name of a minor, the nomination shall be made by a person lawfully entitled to act on behalf of the minor.

(f) The nominee can be a minor. The depositor may, while making the nomination, appoint another individual not being a minor, to receive the amount of the deposit on behalf of the nominee in the event of death of the depositor, or as the case may be, all the depositors during the minority of the nominee.

(g) In case Safe Deposit Lockers in joint names without survivorship benefit, nomination can be made in favour of more than one person. A minor is not accepted as a nominee in case of safe deposit lockers.

(h) In case of death of a sole depositor/all the joint depositors, the name of the nominee can be substituted at his written request in the deposit account/receipts including overdue deposits.

(i) The nomination may be varied or cancelled by the depositor in the prescribed manner. In case of a joint account, variation or cancellation of a subsisting nomination can be made by all the surviving depositors acting together.

On making payment under the provisions of this Section, the banking company shall be fully discharged from its liability in respect of the deposit. The right or claim of any other person against the nominee, to whom any payment is made under this section, shall not be

affected by such payment. No other person shall be able to get notice of his claim to such deposits to the banking company. Nor shall the banking company be bound by such notice even through expressly given to it.

Non-Resident Account

The non-resident account is defined as "the accounts maintained with banks in India by persons, companies, firms, banks etc., resident or situated outside India." When the account opens in the name of persons, firms, companies or associations it is referred to as 'Private Non-Resident Account'. While in the case of banks such accounts are called as 'Non-Resident Accounts'.

It should be noted that a non-resident means a citizen of India who is living outside India in the following cases:

(a) Taking up employment outside India.
(b) Carrying on business outside India.

Recent Development

There are no major policy changes in the regulations governing Foreign Currency Non-Resident Accounts (FCNRA) and Non-Resident (External) Rupee Accounts [NR (E) RA] except for the conversion rate to be applied for such remittances to NRE A/Cs which is covered under the head of Liberalised Exchange Rate Management System (LERMS). The budget for 1992-93 has cited two more facilities to Non-Resident Indians (NRIs) which are given below:

1. **Gold Import Scheme:** The NRIs and returning Indians are permitted to import gold up to 5 kg. on the payment of duty of Rs. 440 per 10 gms in Foreign Exchange. The duty was reduced to Rs. 220 per 10 gms subsequently. Each NRI coming from abroad will be able to bring into India a maximum of 5 kg. of gold provided the person concerned had spent at least six months abroad. NRIs can avail themselves of the facility once in six months.
2. **New Deposit Scheme:** (With Flexible Deposit Rates): This scheme was effective from June 15, 1992. This scheme covers the following:
   (a) Authorised Dealers (ADs) can open these accounts with fresh foreign inward remittances or transfers from existing NRE/FCNR accounts.
   (b) The deposit can be accepted for a minimum period of six months and maximum period of three years.
   (c) The deposit will not be included in the net demand and time liabilities (NTL) of the banks and hence these are free from reserve requirements.
   (d) Principal and interest are not repatriable.
   (e) Once these deposits are withdrawn, these benefits cannot be extended even if the deposit is redeposited in other banks.

3. **Home Loan Account Scheme:** The Home Loan Account Scheme which has been in operation since July 1, 1989, has now been extended to select housing finance companies and Apex Co-operative Housing Finance Societies. Under this scheme more than 12 lakh accounts have been opened by the end of November 1997. The amount of deposits collected was about Rs. 100 crores.

Conclusion

To conclude, it is rightly said that the relationship between a bank and a customer begins when the customer opens an account with the bank. For the attraction of customers the banks offer different types of facilities. In order to avoid meaningless competition among several banks the Reserve Bank of India has been given the power to fix deposit interest rates. For this purpose, the RBI issues directives from time to time.

Here, it is made clear that all the accounts are opened with the bank with the cash money by the customer and that is why, in other words, these are known as "Deposit Accounts." Under Section 6 of the Banking Regulation Act 1949, the most important function of a modern bank is to accept deposit of money from the public. The banks have, therefore, introduced different types of accounts with various facilities and privileges.

Questions for Discussion

1. Explain the different types of accounts which a person can open with a bank.
2. What is the difference between Current, Savings and Fixed Deposit accounts? Explain.
3. What procedure does a banker follow in opening a new account? Explain.
4. Discuss the various forms used in the operation of a savings or a current account.
5. What is a Recurring Deposit Account?
6. Briefly explain the various types of accounts a bank can open.
7. State the circumstances under which a banker can close the account of a customer.
8. Discuss the role of Deposit Insurance and Credit Guarantee Corporation.
9. Write short note on 'Facility of Nomination'.
10. Discuss the accounts that may be opened by the Non-Resident Indians.

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PASS BOOK

INTRODUCTION

A banker receives deposits on current and savings accounts from his customers. The customers are allowed to withdraw the amount from time to time needed by them through cheques or withdrawal slips from the account. The amounts deposited and withdrawn by each customer from time to time are entered in a separate account opened in the name of the customer in the ledger account of the banker. Similarly, the transactions are entered in a book and handed over to the customer for his reference and information. The entries made in the book also stand as evidence of the transactions between the banker and the customer. This book is known as 'Pass Book'.

Meaning of Pass Book

Pass book is an important book in the operation of a bank account. It contains a copy of the customer's ledger account as it appears in the banker's books. It is an exact extract or copy of the customer's account in the bank's ledger, as on a particular date. It is, in other words, a record of dealings between the customer and the bank. It is written by the bank from its own records. It is supplied by the bank to its customer free of charge. It is meant for the information of the customer. It indicates to him the "state of his account" in the bank. The customer sends it periodically to the bank so that upto date entries may be recorded by the bank. As it passes periodically between the banker and the customer, it is called a "Pass Book." Every entry made in pass book is signed by a responsible official of the bank. Some big banks supply periodical statements of account in place of the pass book. In case of foreign accounts, some banks make use of photography to save the labour of writing statements of accounts. The photostat copies of the customer's account are sent to the customers for their approval.

Object or Purpose of Pass Book

The object of a pass book is to inform the customer from time to time the status of his account as it appears on the books of the bank. It supplies evidence in favour of the customer in the event of the litigation or dispute with the bank. In this way, it protects the customer against the carelessness or fraud of the bank. The pass book also enables the customer to prepare "bank reconciliation statement" for the purpose of finding out the causes of difference between the balance as shown by his cash book and the bank pass book.

Statement of Account

Some bankers send periodical statements in duplicate to the customers showing the transactions of the banker with the customer. The customer is required to verify the statement and return one copy to the banker for having satisfied of the correctness of the entries. If any discrepancies are found in the statement, the matter is to be referred back to the banker.

Some bankers also maintain loose leaves of the transactions of the banker with the customer. Photo-copies of the entries in the banker's book are sent to the customer as authenticated copies of the accounts of the transactions.

Examination of Entries

A pass book is a replica of the customer's account with the banker. All money deposited by the customer with the banker will find credit in the accounts of the banker and the withdrawals will be debited. When the pass book is handed over to the customer, it amounts to a statement of account rendered by the bank.

Is it necessary for the customer to examine the pass book? No, in India and United Kingdom, it is not obligatory for the customer to examine the pass book. He needs not discover any error or omission and draw the bank's attention. On failure to examine the pass book, he can't be held guilty of negligence. But if the customer agrees to this by signing the form regarding the accuracy of the balance, it becomes an 'account settled' or 'account stated'. It will be implied in such a case that the balance will be paid as a lump sum by the party agreed to be in debt without reference to the individual items.

BANK OF INDIA
Savings Banks Account

Name..............................

A/c No............................

Date	Particulars	Debit	Credit	Balance	Initials of Bank's Official

Specimen of Folio of Pass Book

Legal Position of Entries in the Pass Book

It is difficult to define precisely the decisive legal effects of entries shown in the pass book. When it is issued to customer and if he does not raise any objection, obviously it becomes "account stated" or "settled account" between him and the banker. But there has been a conflict of opinion regarding conclusiveness of the pass book regarding entries made therein. Sir John Paget is of the view that "the proper function of a pass book is to constitute a conclusive, unquestionable record of the transactions between banker and customer, and it should be recognised as such." He cites Daveyness. Vs Noble case in support of his view. In this case, it was stated that on delivery of the pass book to the customer, he examines it and if there appears an error or omission, sends it back for rectification or if not, his silence is regarded as an admission that the entries are correct. In Vagliana Brothers Vs Bank of England, also it was held that "the return of a balanced pass book by the customer without comments amounts to settlement of account." So, the return of pass book by the customer renders as a stated and settled account as on the particular date of balancing.

But the legal position both in England and in India is quite different. According to recent judicial decisions in England and India, the entries in the pass book cannot be regarded as a conclusive proof of their accuracy and as settled account. Any entry in the pass book is open to comparison and verification by customer. The customer can legitimately question the entries at any time whenever he notices them. The banker is bound to make the suitable corrections. The entries wrongly made or included may be advantages either to the customer or the banker. Both the parties can indicate the mistakes or omissions to get them rectified. So entries made upto date are prima facie evidence and not conclusive evidence. In Keptigulla Rubber Estates Co. Vs National Bank of India, it was held that "When a pass book is returned to the bank by the customer without objection, the account cannot be regarded as settled account and it is not binding on both the banker and customer. In Mowji Vs Registrar of Co-operative Societies, Madras, it was stated that "the entries in the pass book can be regarded as prima facie evidence and not conclusive evidence." Thus entries in the pass book are not conclusive evidence of their correctness, in stating the position of customer's account. They are subject to alternation on the basis of real facts.

Effect of Entries in the Pass Book

The entries wrongly made or included in the pass book may be favourable or advantageous either to the customer or to the banker. So the wrong entries can be divided into two types: (1) entries favourable to customer, and (2) entries favourable to banker.

1. **Entries Favourable to Customer:** The account of a customer may sometimes show a wrong credit balance, which may be due to: (a) duplication of credit entries, or (b) crediting of higher amounts, or (c) omission of any debit entry or (d) crediting the amount belonging to another customer.

   If any entry is made by bank in favour of the customer, the bank can rectify it by due notice to the customer. The customer after such notice cannot withdraw such money. But as long as it is not corrected, the customer acting in good faith can rely

on it as the "stated correct account." Entry advantageous to the customer may be used as evidence against the banker. In Akrokeri Mines Ltd. Vs Economic Bank, it was held that "the pass book belongs to the customer and the entries made in it by the bank are statements on which the customer is entitled to act."

When the customer draws a cheque relying on a larger balance shown in the pass book by mistake, the banker has no right to dishonour such a cheque. If he dishonours, he may be held liable to pay damages. In Holland Vs Manchester and Liver Pool District Banking Company Ltd., the customer's pass book showed a credit balance of £ 70 and accordingly he drew cheque for £ 65. The banker dishonoured the cheque on the ground of inadequate balance. The court held that "the customer is entitled to act upon the representation contained in the pass book as to the amount of his balance and that he is entitled to recover damages in respect of the dishonour of his cheques."

The banker cannot recover the money wrongly credited if the customer can show that in good faith and relying upon the accuracy of the entry he had been induced to alter his position. This point was decided in Skying Vs Greewood. In this case, the bank wrongly credited the account of a military officer. The military officer relying on the pass book drew cheques in good faith and spent the amount. When the mistake was detected, the bank saught to recover the amount wrongly credited. It was held that "the bank was not entitled to recover the amount on the ground that the customer relying on the statements sent by the bank altered his position by spending the amount." In this case the customer also acted in good faith. But this favour is not available to business people. The business man is expected to keep regular accounts and know the position of his bank account. So he cannot take advantage of an error, knowingly. This point was decided in Rhind Vs Commercial Bank of Scotland.

2. **Entries Favourable to Banker:** Entries that are favourable to a banker arise when a credit entry has been totally omitted or wrongly stated, or any debit entry has been wrongly made in the customer's account. The legal position in this regard is stated below:
   (1) The customer can get the mistake rectified as soon as it is detected. This right exists even after he returns the pass book. He can recover the wrongly debited amount or the credit which is omitted.
   (2) However, the customer will not be entitled to get the mistake rectified if it is proved that:
      (a) The customer was negligent.
      (b) The entries in the pass book constitute a settled account, and
      (c) The position of the banker has been subsequently altered to its prejudice.

It is doubtful as to what act or omissions on the part of the customer amount to settlement of an account or negligence in regard thereto. Entries made in the pass book favouring the

bank, under a mistake, cannot be treated as settled account even though customer fails to find out the mistakes. They are liable for correction when forgeries or mistakes are brought to notice. If the customer knowing that some of his cheques are forged does not immediately inform the banker, then he is taken to be guilty of negligence and accordingly he cannot question the correctness of the entries in the pass book. In Greenwood Vs Martins Bank, a wife of a customer forged the cheques and drew the amount. The husband kept silent though knowing of the forgeries. On the death of the wife, the husband informed the bank about the forgeries and claimed refund. It was held that he could claim because the banker was guilty of negligence. Silence might not be objectionable. But deliberate silence under circumstances when it was his duty to inform would arise an estoppel.

Now-a-days many banks follow the practice of getting the pass book balance confirmed by the customer in writing. Banks at the end of every half year send letters to customer informing the balance in his account and is requested to confirm in writing the balance stated. Usually a slip is attached to the letter and the customer is required to return it duly signed. It is, however, essential for the banker to be cautious and accurate in posting the entries in the pass book.

Precautions in Writing a Pass Book

While writing the pass book, the bank should take the following precautions:

(1) The customer should be requested to present the pass book for completion periodically.

(2) All the entries in the pass book must be invariably installed by a responsible official as a proof of having verified the entries.

(3) The pass book must be returned to the customer after it is updated so that he has an opportunity of examining it.

(4) When the pass book is sent back or handed over the customer, the date should be noted in the ledger together with initials of the clerk who writes it.

(5) While sending the pass book to the customer, the banker should take steps to ensure the secrecy of its contents.

(6) In case of loss of pass book, duplicate copy should be marked with the word "Duplicate" and the fact should be recorded in the ledger also.

(7) The banker should indicate to the customer to intimate the objections, if any, from time to time.

(8) Confirmation letter should be sent to the customer regarding the balance standing to the credit of his account. A certificate may be enclosed alongwith the statement of account asking for an acknowledgement of the balance as correct. If the account shows a debit balance, it will operate as an acknowledgement of debt and would extend the period of limitation.

Conclusion

To conclude, a pass book is a small book issued by the bank to the customer which contains the record of transactions between the bank and the customer. It is an extract or a copy of the account of the customer in the bank's ledger as on a particular date. It is written by the bank from its records and is meant for the use of the customer. It is called a pass book because it frequently passes between the bank and the customer.

Questions for Discussion

1. Explain pass book with the help of a specimen. Is it necessary for a customer to examine the pass book?
2. State the legal effect of entries made in favour of customer in the pass book.
3. State the legal effect of entries made in favour of banker.
4. List the precautions which a bank should take while writing a pass book.

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Cheques

INTRODUCTION

In the olden days, when Goldsmiths were working as bankers, people used to deposit their savings with them with an understanding that whenever they needed funds, the depositors would draw notes. These notes or letters were nothing but small pieces of paper containing a small note addressed to a particular Goldsmith asking him to pay a particular sum of money to the party who presented such a note. It was drawn by the depositor. At a later stage, these notes became cheques.

Every bank has its own printed cheque forms which are supplied to the account holders at the time of opening the accounts. These forms are printed by expert printers on special security paper which is sensitive to chemicals. This is done in order to make chemical alterations, if any, noticeable. Cheques must be drawn on these forms only. The customers may obtain a new cheque book when the old one is finished or is about to finish, by signing the requisition slip provided in the cheque book towards the end. If a customer desires to have more than one cheque book, one to draw cash and another to be issued to his suppliers etc., the bank may have such cheque leaves printed with the crossing as well as superscripts like 'Account Payee' and 'Not negotiable' thereon.

Meaning

A cheque is a negotiable instrument governed by the provisions in the Negotiable Instrument Act. It is an unconditional order, drawn on a specified banker, signed by the drawer, directing the banker, to pay on demand, a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.

Definition

Under Section 6 of the Negotiable Instruments Act, 1881, a cheque is defined as a "bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand." To understand this definition, it is necessary to know the definition of a Bill of Exchange.

According to Section 5 of the Indian Negotiable Instruments Act, 1881: "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."

Essentials

From the above definition it follows that an instrument to be called a cheque must fulfil certain conditions. They are:

1. It is an instrument in writing;
2. It contains unconditional order;
3. It is drawn by the drawer;
4. It is drawn upon a specified banker;
5. To pay a certain sum of money;
6. Payable on demand;
7. Payable to a certain person or his order or to the bearer of the instrument.
8. A cheque should be properly dated
9. It is signed by the maker
10. There are three parties to a cheque, viz
    (a) Drawer (b) Drawee, and (c) Payee.

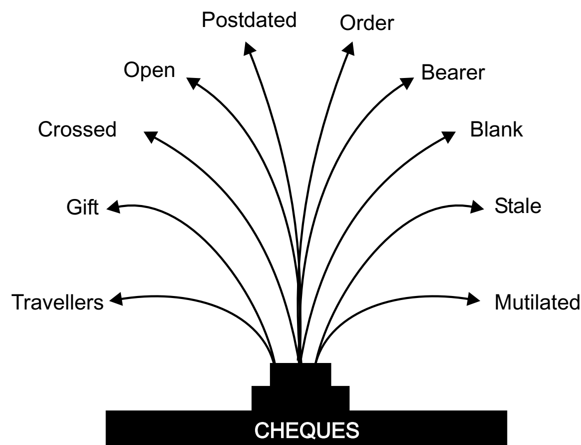
These are discussed below:

1. **Instrument in Writing:** A cheque or a bill of exchange is an instrument in writing. Legally speaking the writing may be done by means of printed characters, type-writer, or by a pen or pencil. But bankers do not generally honour cheques drawn in pencil, unless confirmed by the drawer. This is because, it is easy to make unauthorised alterations when a cheque is drawn in pencil.
2. **Contains Unconditional Order:** The instrument must contain an unconditional order. For instance, if the banker is ordered to pay a certain sum provided the payee fulfils certain conditions, it cannot be considered a cheque as the order is a conditional one. However, if such instruments are addressed to the payee and not to the banker, the order to pay may be regarded unconditional.
3. **Drawn by the Drawer:** A cheque is to be drawn or taken out only by the drawer or the account holder. The account holder being a customer of the bank has an account wherein he has deposited his funds. He is the rightful or authorised person to draw the cheques for making payments and for that he has to sign the cheques himself.

4. **Drawn Upon a Specified Banker:** The account holders, whenever they desire to make payments, are expected to draw cheques on a banker and not on an individual. Further, the banker should be specific, i.e., his name and address should be definite.
5. **To Pay a Certain Sum of Money:** The order of the drawer of a cheque must be payed a certain sum of money and not anything else e.g., securities or goods etc. The amount of money to be paid must be certain and specified both in words and figures.
6. **Payable on Demand:** According to Section 19 of the Negotiable Instruments Act, 1881, when the instrument does not specify for payment, it is always payable on demand. Unless and until a demand is made, the amount in respect of the cheque would not be paid. Demand is necessary to make the banker liable to pay the amount of the cheque.
7. **Payable to a Certain Person or his Order or to the Bearer of the Instrument:** The amount mentioned in the cheque should be paid to a specific person or payee or according to his order. Or it may be made payable to the bearer. Or it may be made payable to the bearer of the instrument.
8. **It is Signed by the Maker:** The maker must sign the instrument. In order to be a valid cheque, the instrument must contain the signature of the drawer. In the case of an illiterate person, his thumb impression will suffice. Though legally permissible, pencil signatures are discouraged by bankers. So also signatures impressed on the cheque by means of a rubber stamp is not permitted generally.

Types of Cheques

Cheques are of the following types:



1. **Order Cheque:** A cheque which is payable to a particular person or his order is called an order cheque.
2. **Bearer Cheque:** A cheque which is payable to a person whosoever bears, is called bearer cheque.

3. **Blank Cheque:** A cheque on which the drawer puts his signature and leaves all other columns blank is called a blank cheque.
4. **Stale Cheque:** The cheque which is more than six months old is a stale cheque.
5. **Multilated Cheque:** If a cheque is torn into two or more pieces, it is termed as mutilated cheque.
6. **Post Dated Cheque:** If a cheque bears a date later than the date of issue, it is termed as post dated cheque.
7. **Open Cheque:** A cheque which has not been crossed is called an open cheque. Even if a cheque is crossed and subsequently the drawer has cancelled the crossing at the request of the payee and affixes his full signature with the words "crossing cancelled pay cash", it becomes an open cheque.
8. **Crossed Cheque:** A cheque which carries too parallel transverse lines across the face of the cheque with or without the words "I and co", is said to be crossed.
9. **Gift Cheques:** Gift cheques are used for offering presentations on occasions like birthday, weddings and such other situations. It is available in various denominations.
10. **Traveller's Cheques:** It is an instrument issued by a bank for remittance of money from one place to another.

Uses of a Cheque

1. If payment is made by means of a crossed cheque, receipt need not be obtained.
2. It is also convenient to receive money.
3. Payment can be made to a particular person by drawing up crossed "Account payee" cheques.
4. The cheque is 'near money' and hence is endorsable from one person to another to settle the effects.
5. It minimises the operation of legal tender money and the bankers can operate with a less amount of cash reserves.
6. No need of counting cash while making payment.
7. If a crossed cheque is lost, only a piece of paper is lost, i.e., the amount remains intact.
8. If payments are made by cheques an automatic record of the account is also maintained in the banker's books.

Advantages of Using Printed Forms

Printed cheques have the following advantages:

1. It is very convenient to the banker as well as to the customer.
2. The customer need not draft the contents of the cheque. He naturally saves time and labour.
3. Printed cheques conform to the definition given in the Negotiable Instruments Act.
4. Any alteration in the cheque can be observed immediately.

5. It helps to identify the drawer as the details of the cheque are recorded in the books of the banker.
6. Only the account holders will be supplied with the printed forms. Others cannot posses it. Hence the forgery has been minimised.
7. Since the cheque forms have serial numbers, it is not only easy to identify the cheque but also, if need, countermanding instructions can be given.
8. Since every cheque leaf has a counter foil, it is very useful to the customer to verify his account and other connected details.

Parties to a Cheque

Basically there are three parties to a cheque viz., (1) Drawer (2) Drawee, and (3) Payee.

1. **Drawer:** A drawer is the person who has an account in the bank and who draws a cheque for making payment. He is the customer or account holder.
2. **Drawee:** A drawee is the person on whom the cheque is drawn. He is liable to pay the amount. In case of a cheque, the drawee happens to be the banker on whom the cheque is drawn, he is also called the Paying-Banker.
3. **Payee:** A payee is the person to whom the amount stated in the cheque is payable. It may be either drawer himself (self cheques) or only other third party states in the cheque.

MATERIAL ALTERATIONS

Alteration

A cheque may be altered by the drawer or by a third party after it is drawn. For example, the date of cheque may be altered or the amount payable may be altered. Alteration may be made genuinely or fraudulently. Alterations may be material or immaterial.

Material Alteration

An alteration is regarded as material when it alters materially or substantially the operation of the instrument and liabilities of the parties thereto. It is defined as “an alteration which alters the business effects of the instrument if used for any business purpose.” So any change in an instrument which causes it to speak a different language in legal effect from that which it originally spoke, or which changes the legal identity or the relation of the parties to it, is a material alteration.

Examples of Material Alterations

Material alterations refer to change of the date, place of payment, amount, payee’s name, crossing etc. The following are some of the examples of material alteration:

(a) Alteration of the date of the instrument.
(b) Alteration of the sum payable.

(c) Alteration of the place of the payment.
(d) Alteration of the name of the payee.
(e) Alteration of the crossing marks.
(f) Alteration in the rate of interest.

Examples of Authorised Alterations

Under the Negotiable Instruments Act, 1881, the following do not amount to material alterations:

(a) Filling blanks of the instrument.
(b) Conversion of blank endorsement into an endorsement in full.
(c) Making acceptance conditional.
(d) Altering a general crossing into a special crossing.
(e) Crossing of an uncrossed cheque.
(f) Alteration made with the consent of the parties.

Examples of Non-material Alterations

Immaterial alteration will not affect the validity of the instrument. They do not affect the rights and liabilities of any party. They have insignificant effects. They are as follows:

(a) Alteration made for correcting mistake.
(b) Alteration made to carry out the intention of the original parties.
(c) Alteration made with the consent of the parties.
(d) Alteration which is the result of an accident.
(e) Alteration made before issue or delivery of the instrument.

Effects of Material Alteration

A cheque containing material alteration cannot be regarded as a cheque at all. A cheque with erasers and alterations is not valid against the banker. Under the Indian law such a cheque is void. According to Section 87 of the Negotiable Instruments Act "any material alteration renders the instrument void against anyone who is a party thereto, and who has not consented to such alteration." So a banker who finds a cheque materially altered in its contents has to dishonour it, unless it is duly attested by the full signature of the drawer. Such refusal to pay will not amount to wrongful dishonour. Sheldon says "the banker can honour a cheque which bears the drawer's confirmation of any alteration." Material alterations are to be authenticated by the drawer. But the banker cannot refuse to pay a cheque whose alterations are not of material significance, or which are authorised by Act or which are made with the consent of the parties. If a banker pays a cheque bearing unauthorised alterations, he cannot debit the drawer's account and is liable to the true owner. The case illustrating the point is Slingsly and others Vs The West Minister Bank Limited.

The banker should take all precautions to see that the cheque is free from material alterations before paying it. The banker should carefully scan the cheque with the help of

the magnifying glass or other mechanical appliances of forgery detection to see that the amount is not altered. However, the paying banker gets protection where the alteration is apparently not noticeable and the payment is made in due course. The paying banker is also protected, from wrong payment of an altered cheque if the customer is found to have negligently drawn the cheque. It is the duty of the drawer also to draw the cheques with great care. In Macmillan Arthur Vs London Joint Stock Bank it was stated that "the Customer is bound to exercise care in drawing the cheque in such a way as not to give scope for alteration."

From the above discussion, it is clear that in order to discharge the parties liable on the instrument as cheque, an alteration should be a material one and none authorised by the Act and it should also be apparent on the face of the instrument.

CROSSING OF CHEQUES

Crossing first originated in England when cheques were sent from one bank to another. There was the possibility that a cheque might fall in the hands of wrong or unauthorised parties and thereby the original holder was likely to be put to a loss or inconvenience. To avoid this disadvantage, the bankers introduced this new system of crossing of cheques. Crossing automatically means that a cheque should be presented for payment through a bank.

Meaning of Crossing

Crossing of cheques means drawing two parallel transverse lines on the left hand top corner of a cheque. Sometimes, it is also done in the centre of the cheque.

The Negotiable Instruments Act 1881, recognises crossing of cheques. A crossing is a direction to the paying banker that the cheques should be paid only to a banker and if the banker is named in the crossing, only to that banker.

This ensures the safety of payment by means of cheques. The holder of the cheque is not allowed to cash it across the counter.

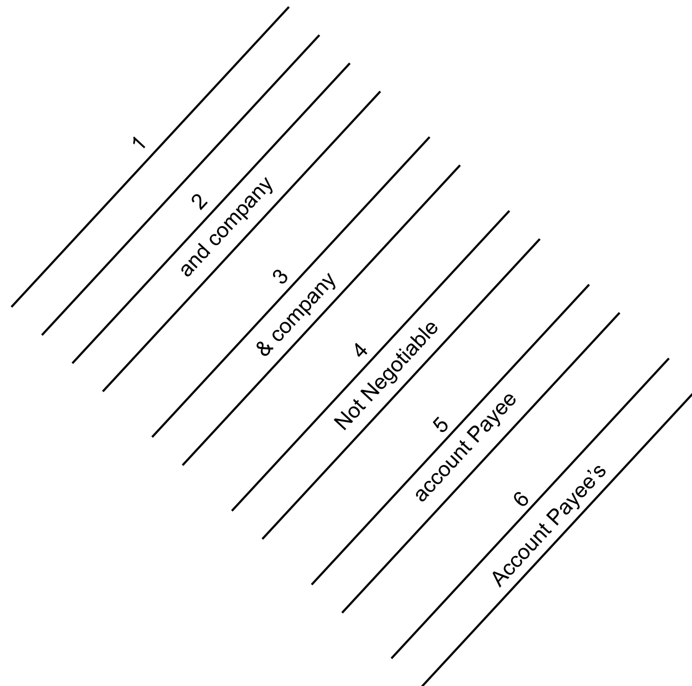
Types of Crossing

Cheques can be crossed in two ways (1) General Crossing (2) Special Crossing.

1. **General Crossing:** Section 123 of the Negotiable Instruments Act 1881, defines a general crossing as follows:

"Where a cheque bears a cross its face an addition of the words '& company' or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply either with or without the words 'not negotiable' that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally."

Some specimens of general crossings are given below:



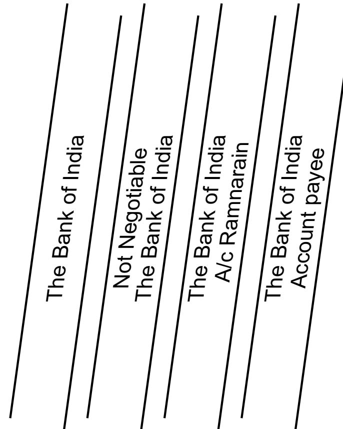
It is to be noted from the above that the drawing of two parallel transverse lines on the face of the cheque constitutes “General Crossing.” The lines must be (a) on the face of the cheque, (b) parallel to each other, and (c) in cross direction (*i.e.,* transverse). Inclusion of words ‘and company’ is immaterial and of no special consequence.

The effect of general crossing is that the cheque must be presented to the paying banker through any other banker and not by the payee himself at the counter. The collecting banker credits the proceeds to the account of the payee or the holder of the cheque. The latter may thereafter withdraw the money.

Special Crossing

Section 124 of the Negotiable Instruments Act 1881, defines a special crossing as follows:

“Where a cheque bears a cross its face, an addition of the name of a banker, either with or without the words ‘ not negotiable’, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be crossed to that banker.” Following are given specimens of special crossing:

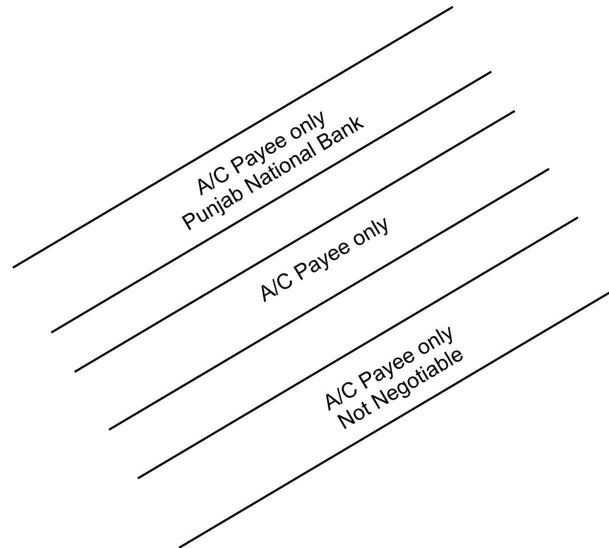


The Special Crossing on the cheque is a direction to the paying banker to honour the cheque only when it is presented through the bank mentioned in the crossing and no other bank. The cheque crossed specially thus becomes more safe than the generally crossed cheque. The banker, to whom a cheque is specially crossed, may appoint another banker as his agent for the collection of such cheques.

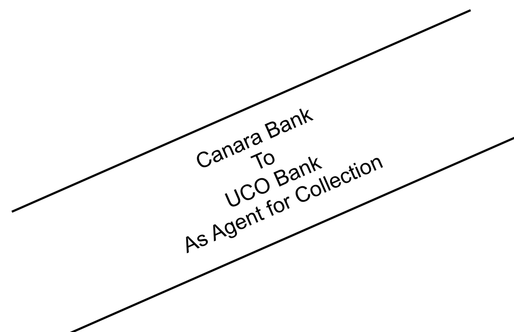
Other Types of Crossing

Besides the above two types of crossing, in recent years, the following types of crossing have been developed:

1. **"Not Negotiable" Crossing:** According to Section 123 and 124 of the Negotiable Instruments Act, 1881, a cheque may be crossed either generally or specially with the words "not negotiable." The impact of these words is given in Section 130 of the said Act. The Section 130 of the said Act states, "A person taking a cheque, crossed generally or specially, bearing in either case the words "not negotiable" shall not have and shall not be capable of giving a better title to the cheque than that what the position from whom he took it had." Whereas the cheque is crossed with the words "not negotiable," the bank must be careful in paying such cheques. In such a case, the payment must be made only after the bank is satisfied that the person demanding payment, is the person entitled to get it in reality.
2. **Restrictive Crossing or Account Payee Crossing:** Restrictive or Account Payee Crossing means "a direction to the collecting banker that the proceedings of the cheque are to be credited only to the account of payee named, written or mentioned in the cheque. It is to be noted here that the words "Account Payee" are not recognised by the Negotiable Instruments Act, 1881. The words 'Account Payee Only' constitute an instruction to the collecting banker that he should collect the amount of the cheque for the benefit of the payees only (Nobody can get any benefit except payee). The specimen forms of restrictive crossing are shown below:



3. **Double Crossing:** According to Section 127 of the Negotiable Instruments Act, 1881: "Whereas a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereon." This type of crossing may be used only when the banker in whose favour the cheque is specially crossed does not have any branch at the place where the cheque is to be paid. A specimen of such a crossing is given below:



Significance of Crossing

In the case of general crossing, the addition of the words "& Co." does not have any legal significance; but the words "not negotiable" have legal significance. By crossing a cheque generally the person who is not entitled to get its payment, is prevented from getting the cheque cashed at the counter of the paying banker. While in the case of special crossing, the name of the banker must be written on the face of the cheque, to whom or to whose collecting agent, payment of cheque is to be made. It is to be noted that the lines are not essential for a special crossing. By crossing a Cheque specially, it is quite safer than the

generally crossed cheque. In such a case the banker to whom a cheque is crossed specially, may appoint another banker as his agent for the collection of such cheques. Such cheques may be sent through ordinary post.

In short, a cheque can be crossed by the drawer, holder or banker. Section 125 of the Negotiable Instruments Act states, "Whereas a cheque is crossed generally or specially, the holder may add the words 'not negotiable.'" In the case of a banker, the above Section further states: "whereas a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker as his agent for collection." While in the case of a drawer, he has the right to cancel the crossing by putting his full signature and writing the words "Pay Cash."

ENDORSEMENT

Endorsement literally means "writing on the back of the instrument." But under Negotiable Instruments Act, it means "writing of a person's name on the back of the instrument or on any paper attached to it for the purpose of negotiation." The person who signs the instrument for the purpose of negotiation is called the "endorser." The person to whom the instrument is endorsed or transferred is called the "endorsee." Mere endorsement is not sufficient unless the instrument is delivered to the endorsee. The endorsement is completed by delivering the signed instrument to the endorsee. The purpose or object of endorsement is negotiation or transfer of the instrument.

Definition of Endorsement

According to Section 15 of the Negotiable Instruments Act "when the maker or holder of a negotiable instrument signs his name, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper attached thereto, he is said to have endorsed the instrument." Thus a person entitled to get money on a negotiable instrument can transfer his right to another. He may be a maker or holder of the instrument. If he wants to transfer his right to another, he must sign the instrument. The signature is usually made on the bank of the instrument.

Essentials of a Valid Endorsement

The following are the essentials of a valid endorsement:

(a) Endorsement must be on the back or face of the instrument. If no space is left on the instrument, it must be made on a separate paper attached to it.
(b) It should be made in ink. An endorsement in pencil or rubber stamp is invalid.
(c) It must be made by the marker or holder of the instrument. A stranger cannot endorse it.
(d) It must be signed by the endorser.
(e) It must be completed by delivery of the instrument.
(f) It must be an endorsement of the entire bill. A partial endorsement does not operate as a valid endorsement.

Kinds of Endorsement

Endorsement may be of any of the following kinds:

1. Blank endorsement,
2. Special endorsement,
3. Partial endorsement,
4. Restrictive endorsement,
5. Conditional endorsement.

1. **Blank Endorsement:** It is also called "general endorsement." An endorsement is said to be blank if the endorser signs his name only on the face or back of the instrument. Endorsement in blank specifies no endorsee. It simply consists of the signature of the endorser on the endorsement. A negotiable instrument even though payable to order becomes a bearer instrument if endorsed in blank. Thus, a blank endorsement converts an order instrument into a bearer one. It is negotiable by delivery of the instrument.

   Example: A bill is payable to the order of Swaroop. Swaroop signs on the back of the bill. This is an endorsement in blank by Swaroop. The bill becomes payable to bearer and is negotiable without any further endorsement.
2. **Special Endorsement:** It is also called "full endorsement." In this type of endorsement, the name of the endorsee is specifically stated. If the endorser adds direction to pay the amount mentioned in the instrument to, or to the order of a specified person, the endorsement is said to be special. In other words, it specifies the person to whom or to whose order the cheque is to be payable. A blank endorsement can be easily converted into a special endorsement by any holder of negotiable instrument.

   Example: (a) "Pay to x or order", (b) Pay to the order of x
3. **Partial Endorsement:** If an instrument is endorsed for a part of its amount, such an endorsement is said to be partial. Similarly, if an instrument is endorsed to two or more endorsees separately and not jointly, the endorsement becomes partial. Such an endorsement does not operate as a negotiation of the instrument. No right of action arises under a partial endorsement. It is invalid.

   Example: The holder of a promissory for Rs. 1,000 writes on it pay B Rs. 500 and endorses the note. The endorsement is invalid for the purpose of negotiation.
4. **Restrictive Endorsement:** An endorsement is said to be restrictive when it prohibits or restricts the further negotiability of the instrument. It merely gives the holder of the instrument the right to receive the amount on the instrument for a specific purpose. It does not give power to him to transfer his rights in endorsement to any one else. "Pay X only" or "pay X for my use" are examples of restrictive types of endorsement.
5. **Conditional Endorsement:** It is also called "qualified endorsement." An endorsement where the endorser limits or negatives his liability by putting some

condition in the instrument is called a conditional endorsement. If for instance, the endorser endorses an instrument with the words "pay A or order on his marrying B," the endorsement becomes conditional. A conditional endorsement, unlike the restrictive endorsement, does not affect the negotiability of the instrument. It does not invalidate the instrument. An endorsement may be made conditional in any of the following forms:

(a) *'Sans recourse' Endorsement:* An endorser may, by express words, exclude his own liability thereon to the endorsee or any subsequent holder in case of dishonour of the instrument. Such an endorsement is called an "endorsement sans recourse" (without recourse). "Pay to A or order without recourse to me" is an example of this type of endorsement. The endorser "sans recourse" is however, liable to the previous endorsers.

(b) *Facultative Endorsement:* An endorsement where the endorser extends his liability or gives up some rights under a negotiable instrument, is called a "facultative endorsement." "Pay A or order, notice of dishonour is waived" is an example of facultative endorsement. Thus, endorser makes himself liable to subsequent endorsees of the cheque even though no notice of dishonour is received by him from the holder. In this type of endorsement, the holders duties towards the endorser are waived.

(c) *'Sans Frais' Endorsement:* Where the endorser, does not want the endorsee or any subsequent holder to incur any expenses on his account, on the instrument, the endorsement is called "sans frais" endorsement.

Legal Effects of an Endorsement

The endorsement of a cheque of bill or exchange has a varied significance. It has following legal effects:

(a) It transfers the property in the negotiable instrument.
(b) It gives the right to sue the acceptor of the bill for recovery of the amount due thereon.
(c) It gives the right to recover from the endorsee and those above him on dishonour.
(d) It gives the holder the right of further negotiation to any one he pleases.

Differences between a Bill of Exchange and Cheque

All cheques are bills of exchange, but all bills of exchange are not cheques. The following are the main differences between a bill and a cheque:

1. **Drawee:** A cheque is always drawn on a banker. But a bill can be drawn on any person including a banker.
2. **Payable on Demand:** A cheque is always payable on demand. As a matter of fact, a cheque is meant for immediate payment. But a bill of exchange may be payable on demand or on the expiry of a fixed period.

3. **Days of Grace:** Three days of grace are allowed on bills payable after a certain period of time. No grace days are allowed in the case of a cheque since a cheque is payable on demand.
4. **Acceptance:** A bill of exchange requires acceptance of drawee. But a cheque requires no acceptance and is intended for immediate payment.
5. **Payable to Bearer on Demand:** A cheque can be made payable to bearer on demand, but a bill of exchange cannot be drawn payable to bearer on demand.
6. **Notice of Dishonour:** Notice of dishonour of a bill is necessary. No such notice is required in the case of a cheque.
7. **Stopping the Payment:** The payment of cheque may be countermanded or stopped by the customer or drawer. But payment of a bill after acceptance cannot be countermanded or stopped by the drawer.
8. **Crossing:** A cheque can be crossed generally or specially. But a bill of exchange cannot be crossed. There is no provision for "Crossing a bill of exchange."
9. **Stamping:** A bill of exchange must be properly stamped. But a cheque does not require any stamp.
10. **Statutory Protection:** A banker is given statutory protection with regard to payment of cheques in certain cases. No such protection is available to the drawee or acceptor of a bill of exchange.
11. **Noting and Protest:** A cheque need not be noted or protested when dishonoured. It is generally inland. But a bill may be noted or protested for dishonour. It may be inland or foreign bill.
12. **Discounting:** A cheque cannot be discounted. But a bill can be discounted and rediscounted with the banks.
13. **Sets:** Cheques are not issued in sets. But foreign bills are generally drawn in sets of three.
14. **Circulation:** A cheque is not intended for circulation but for immediate payment. But a bill is circulated by endorsing it.

Distinguish Between a Cheque and a Promissory Note

The following are the differences between a cheque and a promissory note:

Cheque	Promissory note
1. **Number of parties** A cheque has three parties, namely drawer, drawee and payee.	1. A Promissory note has two parties, namely, maker and payee.
2. **Order and promise** A cheque contains an unconditional order to the banker to pay the money.	2. A promissory note contains an unconditional undertaking by the debtor to pay the money.

Contd...

	Cheque		Promissory note
3.	**Drawee** The drawee of a cheque is always a banker.	3.	A promissory note may be executed either by a banker or by a non-banker.
4.	**Payable on demand** A cheque is always payable on demand.	4.	A promissory note may be payable either on demand or after a certain period.
5.	**Bearer or order** A cheque may be payable to order or to bearer.	5.	A promissory note cannot be made payable to the bearer on demand.
6.	**Crossing** A cheque can be crossed.	6.	There is no practice of crossing a promissory note.
7.	**Stamping** A cheque does not require any stamp.	7.	A promissory note must be properly stamped.
8.	**Days of grace** Grace days are not allowed because the cheque is always payable on demand.	8.	A grace period of three days is allowed.
9.	**Discounting** A cheque is not discounted.	9.	A promissory note can be discounted and rediscounted with banks.

HOLDER AND HOLDER IN DUE COURSE

Holder

According to Section 8 of the Negotiable Instruments Act, a holder means "any person entitled in his own name to the possession of the negotiable instrument and to recover or receive the amount due thereon from the parties liable thereto." A holder must, therefore, have the possession of the instrument and also the right to recover money in his own name. In other words, a holder must be in possession of it under a legal title. Holder implies de jure holder and not de facto holder.

Thus, a person who is in possession of the instrument may or may not be a holder. For example, a finder of lost instrument or a thief cannot be a holder. Similarly, a beneficiary or an agent in possession of an instrument will not be a holder. But legal representatives of deceased holder or official assignee or official receiver would be treated as holders of the instruments. It is only the holder and no other person, who can give a valid discharge for the instrument.

Holder in Due Course

In English Law, a holder in due course is known as "bonafide holder for value without notice." A holder in due course is a person who acquires a promissory note, bill or cheque bonafide for value and maturity. Section 9 of the Negotiable Instruments Act defines a holder in due course as "any person who for consideration became the possessor of a negotiable instrument if payable

to bearer; or the payee or endorsee thereof, if payable to order, before the amount mentioned in it becomes payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title." In other words, a holder in due course is a person who takes the instrument in good faith and for value.

Thus, a holder in due course must satisfy the following conditions:

(a) He must have obtained the instrument for valuable consideration or value. Consideration must not be void or illegal. The consideration must be valuable and lawful. So, the donee of a negotiable instrument is not a holder in due course.
(b) He must have become a holder of the instrument before the date of its maturity.
(c) He must have become a holder of the instrument in good faith.
(d) He must have taken the instrument complete and regular on the face of it.

It is thus obvious that every holder is not a holder in due course. A holder of a negotiable instrument will not be a holder in due course, if:

(a) he has obtained the instrument by gift, or
(b) he has obtained the instrument for unlawful consideration, or
(c) he has obtained the instrument after its maturity, or
(d) he has obtained the instrument by some illegal method, or
(e) he has not obtained the instrument in good faith.

Privileges of a Holder in Due Course

A holder in due course occupies a privileged position in the law of negotiable instruments. He has a title free from equities. He enjoys certain rights and privileges which an ordinary holder can never possess. These rights and privileges are as follows:

1. **Instrument Purged or Cured of all Defects:** The holder in due course gets the instrument free from all the defects in the title. Once a negotiable instrument passes through the hands of a holder in due course, it is purged or cured of defects. It is like a current coin. Anybody who takes a negotiable instrument from a holder in due course can recover the amount from all parties prior to such holder. An instrument once free from defects is always free.
2. **Liability of Prior Parties:** All prior parties to the instrument (the drawer, acceptor or endorser) continue to remain liable to the holder in due course until the instrument is duly satisfied. The holder in due course can file a suit against the prior parties liable to pay in his own name. Section 36 of the Act states that "every prior party to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied."
3. **Rights in Case of Inchoate Instrument:** An inchoate instrument is one which is incomplete in some respects. A person who has signed and delivered a stamped but inchoate (incomplete) instrument cannot argue as against a holder in due course that the instrument has not been completed according to the authority given by him.

4. **No Effect of Conditional Delivery:** Where a negotiable instrument delivered conditionally is negotiated to a holder in due course, the other parties to the instrument cannot escape liability on the ground that the delivery of the instrument was conditional or for a special purpose only.
5. **Right in Case of Fictitious Bills:** If a bill is drawn on behalf of a fictitious person and is payable to his order, the acceptor is not relieved from his liability to holder in due course because of such fictitious name.
6. **No Effect of Absence of Consideration:** The plea of absence of consideration or unlawful consideration is not available against the holder in due course. The party responsible is liable to make the payment.
7. **Estoppel Against Denying Original Validity of the Instrument:** The plea of original invalidity of the instrument cannot be putforth against the holder in due course by the drawer of a bill of exchange or cheques, or by an acceptor for the honour of the drawer.
8. **Estoppel Against Denying the Capacity of the Payee to Endorse:** The maker of a promissory note or the acceptor of a bill is precluded from denying against a holder in due course the existence of the payee and his capacity to endorse.
9. **Estoppel Against Endorser to Deny Capacity of Prior Parties:** An endorser of the bill by his endorsement guarantees that all previous endorsements are genuine and that all parties had capacity to enter into valid contracts. Therefore, he cannot subsequently deny signature or capacity to contract of any prior party to the instrument.
10. **Every Holder is a Holder in Due Course:** The law presumes that every holder is a holder in due course although the presumption is rebuttable.

Distinction between Holder and Holder in Due Course

The following are the differences between holder and holder in due course:

1. **Entitlement:** A holder is entitled in his own name to the possession of the instrument. But a holder in due course acquires the possession of the instrument for consideration.
2. **Consideration:** In case of holder, consideration is not necessary. The instrument may be given as a gift or donation. But consideration is necessary for becoming a holder in due course. A person cannot be a holder in due course if he had obtained the instrument without consideration.
3. **Before and after Maturity:** A holder may get the instrument even after it has become payable. But a holder in due course must get the possession of the instrument before its maturity.
4. **Title:** A holder does not acquire good title, if the title of any of the prior parties was defective. But a holder in due course acquires good title even though there was defect in the title of any prior parties, provided he had no notice of the defect. His title is free from defects.

5. **Presumption:** Every holder in due course is a holder, but every holder may not be a holder in due course.
6. **Right to Recover the Amount:** All prior parties to a negotiable instrument continue to remain liable to the holder in due course until the instrument is duly satisfied. But a holder of an instrument can recover the amount from maker and the transferor but not all the prior parties.
7. **Privileges:** A holder does not enjoy any special privileges, but a holder in due course enjoys certain special privileges.

Conclusion

The above discussion clearly shows that, a cheque is a negotiable instrument specified in Negotiable Instruments Act, 1881. It is an unconditional order, drawn on a specified banker signed by the drawer, directing the drawee to pay on demand a certain sum of money to or to the order of a specified person or to the bearer of the instrument. The payment of a crossed cheque can be obtained through the bank of the holder. If a cheque is crossed it is easy to trace the person for whose benefit the payment was collected. The crossed cheque is negotiable by mere delivery; it is payable to bearer by endorsement and delivery in case is payable to order.

Questions for Discussion

1. What is a cheque? What are the essentials of a cheque?
2. What is meant by the term 'crossing of a cheque? Explain the different kinds of crossing of a cheque and their significance.
3. What do you mean by the term endorsement and what are the essentials of a valid endorsement? Explain the different types of endorsements.
4. "Every holder in due course must be a holder, but every holder may not be a holder in due course." – Comment.
5. What is meant by material alteration in cheques? Give examples of alterations which are material and those which are not.

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The Paying Banker

INTRODUCTION

The relationship between a banker and a customer is primarily that of debtor and creditor, the respective positions being determined by the existing state of account. If the customer has a credit balance with the bank, he is the creditor and if he has a debit balance with the bank, he is the debtor of the bank. Thus, bank does not work as a trustee of money deposited with it by the customer because, instead of money being set apart in a safe room, it is replaced by a debt due from the bank. When a bank accepts the deposits from a customer, it becomes the debtor of the customer and it will be bound to return the equivalent amount to the customer or his order on demand. In other words, it is the obligation of the bank to honour the cheques issued by the customer if the following conditions are fulfilled:

(a) there is sufficient balance in the account of the customer;
(b) the cheque is properly drawn and presented; and
(c) there is no legal restriction on payment.

Meaning

The banker who is liable to pay the value of a cheque of a customer as per the contract, when the amount is due from him to the customer is called "Paying Banker" or "Drawee Bank." The payment to be made by him has arisen due to the contractual obligation. He is also called drawee bank as the cheque is drawn on him.

The payment has to be made by the banker as per the legal obligation also. Section 31 of Negotiable Instrument Act 1881, says that "the drawee of a cheque, having sufficient funds of the drawer in his hands properly applicable to the payment of such a 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." According to this provision, the

drawee of a cheque, *i.e.,* paying banker has a legal obligations to honour the demand of the drawer or customer. If he fails to pay the money held, he is liable for damages. Thus paying banker has certain obligations to discharge.

While making payment he should be cautious. He cannot honour the cheque when sufficient funds are not available at the credit of the customer. If he pays by oversight he will be running the risk of making good this loss i.e., making payment without having sufficient funds. At the same time he will also run the risk when he dishonours cheque even when sufficient funds are available at the credit of the customer. He is liable for damages for this wrongful dishonour. Thus in both the cases he runs the risk. However, the customer should present the cheque at the branch where the amount is kept and should not raise any objection if the cheque is dishonoured at branches where the customer does not hold the account. But he is at liberty to open accounts in any number of branches and can draw cheques, when he is having sufficient funds in each account.

Precautions for Payment of Cheques

Honouring of cheques drawn by his customer is a very important obligation of a banker. He should not dishonour his customer's cheques without adequate ground. The customer can claim damages for the injury caused to his credit owing to wrongful dishonour of cheques. Further, if he honours a cheque which is not properly drawn or contrary of the instructions of his customer or against the intention of his customer or when the customer has no adequate balance, he gets into trouble. The paying banker in such a condition is said to be in "between the devil and the deep sea." Tanan says "the banker's position in respect of cheques drawn upon him is not enviable. So, the banker has to take care when honouring or dishonouring a cheque drawn by his customer."

Precautions

The banker's duty to pay customer's cheques is delicate and hence, to be handled judiciously as well as cautiously. The banker has to take the following precautions while honouring the cheques of his customers:

1. **Proper Form:** A banker should see whether the cheque is in the proper form. That means the cheque should be in the manner prescribed under the provisions of the Negotiable Instruments Act. It should not contain any condition.
2. **Open or Crossed Cheque:** The most important precaution that a banker should take is about crossed cheques. A banker has to verify whether the cheque is open or crossed. He should not pay cash across the counter in respect of crossed cheques. If the cheque is a crossed one, he should see whether it is a general crossing or special crossing. If it is a general crossing, the holder must be asked to present the cheque through some banker. It should be paid to a banker. If the cheque bears a special crossing, the banker should pay only the bank whose name is mentioned in the crossing. If it is a open cheque, a banker can pay cash to the payee or the holder across the counter. If the banker pays against the instructions as indicated above,

he is liable to pay the amount to the true owner for any loss sustained. Further, a banker loses statutory protection in case of forged endorsement.

Madras Bank Ltd. Vs South India Match Factory Ltd., a cheque was issued by a purchaser in favour of the official liquidator of a company towards the purchase price of certain properties. The bank paid the amount of the crossed cheque to the liquidator across the counter. The liquidator mis-appropriated the amount. The court held that the banker committed breach of statutory duty and was negligent in paying direct to the liquidator over the counter and hence, was not entitled to legal protection.

If it is a ‘Not Negotiable’ crossing, the paying banker has to verify the genuineness of all the endorsements. If it is an ‘Account Payee’ crossing, the banker can credit the account of the payee named in the cheque and not that of any other person.

3. **Place of Presentment of Cheque:** A banker can honour the cheques provided it is presented with that branch of the bank where the drawer has an account. If the cheque is presented at another branch of the same bank, it should not be honoured unless special arrangements are made by the customer in advance. The reasons are:

   (a) A banker undertakes to pay cheques only at the branch where the account is kept.

   (b) The specimen signature of the customer will be with the office of the bank at which he has an account.

   (c) It is not possible for other branches to know that the customer has adequate balance to meet the cheque.

   Bank of India Vs Official Liquidator: In this case, it was held that if customer has an account in a bank which has several branches, the branches at which he has no account are justified in refusing to honour his cheques.

4. **Date of the Cheque:** The paying banker has to see the date of the cheque. It must be properly dated. It should not be either a post-dated cheque or a stale-cheque. If a cheque carries a future date, it becomes a post-dated cheque. If the cheque is presented on the date mentioned in the cheque, the banker need not have any objection to honour it. If the banker honours a cheque before the date mentioned in the cheque, he loses statutory protection. If the drawer dies or becomes insolvent or countermands payment before the date of the cheque, he will lose the amount. The undated cheques are usually not honoured.

   A stale cheque is one which has been in circulation for an unreasonably long period. The custom of bankers in this respect varies. Generally, a cheque is considered stale when it has been in circulation for more than six months. Banker does not honour such cheques. However, banker, may get confirmation from the drawer and honour cheques which are in circulation for a long time. So, verification of date is very important.

5. **Mutilated Cheque:** The banker should be careful when mutilated cheques are presented for payment. A cheque is said to be mutilated when it has been cut or torn, or when a part of it is missing. Mutilation may be either accidental or intentional.

If it is accidental, the banker should get the drawer's confirmation before honouring it. If it is intentional, he should refuse payment. The cheque is to be returned with a remark 'Mutilated cheque' or 'Mutilation Requires Confirmation'. In Scholey Vs Ramsbottom, the banker was held liable for wrong payment of a cheque which was dirty and bore visible marks of mutilation."

6. **Words and Figures:** The amount of the cheque should be expressed in words, or in words and figures, which should agree with each other. When the amount in words and figures differ, the banker should refuse payment. However, Section 18 of the Negotiable Instruments Act provides that, where there is difference between the amount in words and figures, the amount in words is the amount payable. If the banker returns the cheque, he should make a remark 'amount in words and figures differ'.
7. **Alterations and Overwritings:** The banker should see whether there is any alteration or over-writing on the cheque. If there is any alteration, it should be confirmed by the drawer by putting his full signature. The banker should not pay a cheque containing material alteration without confirmation by the drawer. The banker is expected to exercise reasonable care for the detection of such alterations. Otherwise, he has to take risk. Material alterations make a cheque void.
8. **Proper Endorsements:** Cheques must be properly endorsed. In the case of bearer cheque, endorsement is not necessary legally. In the case of an order cheque, endorsement is necessary. A bearer cheque always remains a bearer cheque. The paying banker should examine all the endorsements on the cheque before making payment. They must be regular. But it is not the duty of the paying banker to verify the genuineness of the endorsements, unless the cheque bears 'Not-Negotiable' crossing. He is not expected to know the signatures of all payees. So he gets statutory protection in case of forged endorsements. In India, even in the case of bearer cheques, bankers insist on endorsement though it is not required.
9. **Sufficiency of Funds:** The banker should see whether the credit balance in the customer's account is sufficient to pay the cheque or not. If there is an overdraft agreement, he should see that the limit is not exceeded. The banker should not make part-payment of the cheque. He should pay either full amount or refuse payment. In case of insufficiency of funds, the banker should return the cheque with the remark 'No Funds' or 'Not Sufficient Funds'.
10. **Verification of Drawer's Signature:** The banker takes specimen signatures of his customers' at the time of opening the account. He should compare the drawer's signature on the cheque with the specimen signature of the customer. He should carefully examine the signature to find out whether the drawer's signature is forged or not. If there is any difference or doubt, he should not honour the cheque. He should get the confirmation of the drawer. If there is forgery and there is negligence on the part of the banker to detect the same, there is no protection to the banker. In Prabhu Dayal Vs Jwala Bank it was held that payment of a forged cheque cannot be deemed as payment in due course, though the bank may turn out to be an innocent victim.

Statutory Protection

The legal duty of a paying banker is full of risk because payment of cheques may not be made to the right person. In case a payment is made to a wrong person by bank, the loss will be borne by the banker. In banking practice, the banker honours the cheques of his customers and cannot make enquiries and investigations about the title and status of the person who presents the cheque for payment at the counter of the bank. Regarding the payment of a cheque to a wrong person, Chorley observed, "It is obvious that available routine in a bank and the clearing house gives no opportunity for investigation of endorsements, except as to their outward regularity. If enquiries were to be made, much expenditure of time and money would be involved and instrument could only be nominally payable on demand and indeed the system which we know, would be impossible."

Protection Available Under the Negotiable Instruments Act

The Negotiable Instruments Act has come to the rescue of the paying banker and provided protection under certain circumstances. These circumstances are given below:

1. Protection in Case of Bearer Cheque.
2. Protection in Case of Order Cheque.
3. Protection in Case of Crossed Cheque.
4. Protection in Case of Obliterated Cheque.
5. Protection in Case of Drafts.

1. **Protection in Case of Bearer Cheque:** Section 85 (2) of the Negotiable Instruments Act, 1881 states, "Whereas a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any endorsement whether in full or in blank appearing thereon, notwithstanding that any such indorsement purports to restrict or exclude further negotiation."

   The above protection is given in the Act on the basis that a bearer cheque always remains a bearer cheque and it bears endorsement in blank or full whether any endorsement restricts further negotiation or not. In case a bearer cheque is stolen or lost and the banker honours the cheque without any knowledge, the banker will be discharged from his duty under the protection given in Section 85 (2) of the said Act. In such a case, the paying banker is not required to verify the endorsement on bearer cheque.

   In case a bearer cheque is crossed, the paying banker has no right to pay in across the counter in disregard of the crossing.

2. **Protection in Case of Order Cheque:** In case the payment is made to a person other than the payee, the paying banker does not get any protection under the Negotiable Instruments Act. If the endorsement is regular and payment is made in due course, the paying banker gets the protection under Section 85 (1) of the Negotiable Instruments Act, 1881 : "Whereas a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course."

In case, payment is made to a wrong person whose signature is not according to specimen signature, the protection is given to a banker under Section 16 (2) of the Negotiable Instruments Act : "It is not possible for a banker to know each of the endorsers and their signatures." For getting the protection, the banker should note the following:

(a) *Regular Endorsement:* According to Section 85 (1) of the Act the endorsement should be regular. For example, if a cheque is payable to a right person and signature is bearing same name and the same spellings this is known as regular endorsement. Though this is not a valid endorsement.

(b) *Payment in Due Course:* According to Section 10 of the Act the cheque should be paid in due course. In case the payment is made on forged signature of the endorser and not that of the drawer, the banker gets statutory protection under Section 10 of the Act.

3. **Protection in Case of Crossed Cheque:** Regarding payment of crossed cheque, the paying banker gets the protection under Section 128 of the Negotiable Instruments Act, 1881 : "Whereas the banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque and the drawer thereof (in case such cheque has come to the hands of the payee) shall be entitled respectively to the same rights and placed in the same position if the amount of the cheque had been paid to and received by the true owner thereof."

   In case the payment is made on the instructions of the drawer in good faith without any negligence, the paying banker gets the statutory protection under the Negotiable Instruments Act, 1881: "The payment of crossed cheque in due course makes the drawee banker liable to the true owner of the cheque besides disentitling himself to debit the customer's account."

4. **Protection in Case of Obliterated Cheques:** According to Section 89 of the Negotiable Instruments Act, 1881, "Whereas a cheque is presented for payment which does not at the time of presentation appear to be crossed or to have had a crossing which has been obliterated, payment thereof by a banker is liable to be paid and paying the same according to the apparent tenor thereof at the time of payment and otherwise in due course, shall discharge such banker from all liability thereon and such payment shall not be questioned by reason of the cheque having been crossed." Thus the above Section is very meaningful where crossing of a cheque is obliterated by dishonest person. Under the above Section the banker gets the protection in the way that the payment is made according to the apparent tenor of the cheque and due course.

5. **Protection in Case of Drafts:** In case of demand drafts drawn by one branch of a bank upon another branch of the same bank, the banker gets protection under Section 85 of the Negotiable Instruments Act. The Section states: "Whereas any draft, that is, an order to pay money drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand, purports to be endorsed by or on behalf of the payee, the bank is discharged by payment in due course."

In short, a banker may get statutory protection under the various Sections of the Negotiable Instruments Act, if he fulfils the terms and conditions of the said Section of the said Act. No protection, however is available, in case the drawer's signature is forged.

Dishonour of Cheques

A paying banker must refuse payment on cheques, issued by his customers, in the following circumstances:

1. **When the Customer Countermands the Payment:** A banker must refuse to honour cheque when the customer countermands the cheque. Countermands means "the instruction conveyed by the drawer of a cheque to drawee bank not to pay the cheque, when it is presented." The instructions of the customer to stop payment should be in writing. It should be signed by the drawer. The instructions should include the number, the date, the name of the payee and the amount of the cheque. Any one of the partners in partnership accounts or any one of the joint account holders may countermand the cheques. Then the banker has to follow the instructions. Suppose, if there is a request to remove stop order, the banker should get such request signed by all the required signatories. It is better for a banker to suggest the issue of a new cheque. A banker must follow the customer's instructions to stop payment very carefully (Hilton Vs Westminister Bank Ltd.). If instructions are given to stop payment by telegram or telephone, the banker should postpone and request the drawer to send a written confirmation. At best he may return the cheque marking 'Payment Countermanded by Telegram, or 'payment postponed pending confirmation, present again'.

   The banker owes no duty to a holder of cheque. Hence, he should not rely on the instructions from a holder on the plea that he had lost the cheque. He should suggest to the holder to obtain written instructions from the drawer. If the cheque is presented in the meanwhile, he may return the cheque in the case of "stop telegram." However, he should see that the customer's credit is not affected or damaged. If the holder of an order cheque has lost it and informs the banker that he has not endorsed it, the banker should stop payment because the presenter must be claiming the amount through a forged endorsement. Otherwise, the banker will be held liable for not acting in good faith and without negligence.

   If the banker pays a countermanded cheque, he will not only be required to reverse the entry but also be held liable to pay damages for dishonouring the cheques presented subsequently which would have been honoured otherwise.

2. **Notice of the Customer's Death:** The banker should not make payments on cheques presented after the death of the customer. He should return the cheque with the remark 'Drawer Deceased'. However, if the payment is made without knowing the fact of the customer's death, the banker cannot be held liable.

3. **Notice of Customer's Insanity:** The banker should stop the payment on cheques drawn and received after the receipt of notice of the customer's insanity. However, the banker should be very careful in this regard. He can believe that the customer is insane only when the latter is sent to the lunatic asylum. Otherwise, he had to obtain the certificate from the competent doctor. Cheques drawn at a time when the customer was rational may be honoured.
4. **Notice of the Customer's Insolvency:** A banker should refuse payment on the cheques soon after the customer is adjudicated as insolvent.
5. **Receipt of the Garnishee Order:** Where Garnishee order is received attaching the whole amount, the banker should stop payment on cheques received after the receipt of such an order. But if the order is for a specific amount, leaving the specified amount, cheques should be honoured if the remaining amount is sufficient to meet them.
6. **Notice of Assignment:** The banker should stop the payment, on receipt of the notice of assignment signed by the customer of the credit balance in his account.
7. **Trust Accounts:** If the banker feels suspicious that the trustee wants to use the amount of the cheque for his personal use, he must stop payment.
8. **Suspicion about the Title over the Cheque:** When the banker believes that the person presenting the cheque is not entitled to receive the payment, he should refuse to make payment. For example, stolen cheque.

When a Banker can Dishonour Cheques

A banker may dishonour a cheque without incurring any liability in the following cases:

1. **Post-dated Cheques:** Refusal to pay post-dated cheque before the date mentioned on the cheque does not amount to dishonour. So, post-dated cheques can be dishonoured.
2. **Insufficiency of Funds:** The banker can refuse to pay the amount if the funds are not sufficient. However, the banker may honour the cheque if he feels that the customer is a trustworthy and long-standing customer.
3. **Presentation of Cheque:** The banker may refuse the cheque of his customer if it is not duly presented. Presentation of cheque out of business hours, for example, can be dishonoured.
4. **Joint Accounts:** In the case of joint account, the banker can refuse to make payment on the cheque if it is not signed by all the joint account holders.
5. **Material Alterations:** When there is material alteration in the cheque, the banker may refuse payment.
6. **Stale Cheques:** When the cheque is presented after the period of six months from the date it bears, the banker may refuse to make payment.
7. **Drawer's Signature:** If the signature of the drawer on the cheque does not tally with the specimen signature, the banker may refuse to make payment.

8. **Difference between Words and Figures:** If there is difference between the amount written in words and figures, the banker may refuse to make payment.
9. **Endorsement:** If the endorsement is irregular, the banker may refuse payment on the cheque.
10. **Proper Form of the Cheque:** If the cheque is not in the proper form i.e., in accordance with the provisions of the Negotiable Instruments Act, and with conditions, the banker should refuse the payment.
11. **Drawn on Another Branch:** If the cheque is presented at another branch of the same bank, it should not be honoured unless special arrangements are made by the customer in advance.

Bank's Remarks on Dishonoured Cheques

When a cheque is returned unpaid, the banker should attach a slip containing brief remarks, to convey the reason for dishonouring the cheque. The following remarks are generally made:

(a) R.D. (Refer to Drawer): This remark is used only when there is reasonable ground to suspect the veracity of the cheque.

(b) N.S. (Not sufficient), N.E. (No. Effects): These are used where the drawer's balance is inadequate to meet the cheque.

(c) E.I. (Endorsement Irregular)

(d) E.N.C. (Effect is not cleared): This is used when cheques deposited are not yet collected and not available for withdrawal.

Conclusion

In conclusion, it may be observed that the banker must be guided by the recognised practice of bankers. In all cases, the banker must use his own judgement and his knowledge of the general practice of banker.

Questions for Discussion

1. What is paying banker? What precautions should a paying banker take while honouring the cheque of his customer?
2. Under what circumstances can a bank dishonour a cheque of a customer?
3. State and explain the statutory protecting available under the Negotiable Instruments Act to the paying banker.

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COLLECTING BANKER

INTRODUCTION

A banker is not bound to collect cheques and bills on behalf of his customers as it is not a legal duty or obligation. But every modern bank collects cheques and bills on behalf of his customers in order to provide a facility or service to them. This service of collection of cheques on behalf of the customer has become an accepted part of banker's function due to the greater use of the crossed cheques, which are payable through a banker only. In performing this function, he acts as an agent of his customer, and is bound to use reasonable skill, care and diligence.

Meaning

Collecting banker means the banker who collects the cheques and bills on behalf of the customers. In other words, every crossed cheque is necessarily to be collected through any bank, which is known as collecting banker. As Sir John Paget has rightly said "Looking at the restriction on the encashment of crossed cheques, save through a bank and the universal and legally encouraged use of crossed cheques the collection of such cheques must be regarded as an inherent part of banker's business."

While collecting the cheques of a customer, the banker may act in the capacity of either (a) as a holder for value, or (b) as an agent of the customer. The legal position of the collecting banker under these two circumstances is discussed below.

Collecting Banker as Holder for Value

A collecting banker is holder for value if he gives the value of the cheque in any form to its customer before collecting the proceeds of the cheque deposited by the latter. He does not remain an agent of the customer, but becomes the owner of the cheque in his own right since he has paid value for it, and has acquired the ownership right in good faith. In such a situation, the banker is called holder for value and he is also the holder in due course.

According to Paget, a banker becomes an holder for value in the following ways:

(a) by lending further on the strength of the cheque;
(b) by paying the amount of the cheque or part of it in cash or in account before it is cleared;
(c) by agreeing that the customer may draw before the cheque is cleared;
(d) by accepting the cheque in avowed reduction of an existing overdraft;
(e) by giving cash over the counter for the cheque at the time it is deposited in for collection.

In the above circumstances, the banker becomes the holder for value. Further, if he proves that he gave value for a cheque in good faith, he will be able to resist any claim by the true owner provided that (a) the cheque was not tainted with forgery, (b) he had no notice of any previous dishonour or of any defect in the title of his customer, (c) the cheque was not crossed 'not negotiable' (d) the cheque was not overdue for the purpose of negotiation, and (c) the cheque was regular on the face of it in all respects.

If the cheque is dishonoured, the collecting banker can use all the previous parties after giving them the notice of dishonour. The banker undertakes a risk also when he acts as a holder for value. He will be in a difficulty if last, but one endorsement proves to be a forged one. The banker will be liable to the true owner of the cheque. However, he can recover the amount from his customer.

Collecting Banker as an Agent of the Customer

When a collecting banker acts as an agent of the customer, he credits the latter's account with the amount of the cheque after the proceeds of the cheque are actually collected from the drawee banker. The customer can draw the amount after his account is credited with the proceeds. In such a case, banker acts as an agent of his customer and does not get better title to the cheque than that of the customer. If the title of the customer is defective, the banker will run the risk of being liable to the true owner if it collects the cheque. If the cheque collected by the banker does not belong to his customer, the banker will be liable for 'conversion of money' or in other words, for illegally interfering with the rights of the true owner of the cheque.

As an agent of the customer, the collecting banker is a mere "conduit pipe to receive payment of the cheque from the bank on which it is drawn and holds the proceeds at the disposal of the customer." Like any other agent, the banker has to perform his duties diligently for the customer who has paid in his cheques. If he delays or does not exercise the normal skills expected, he will be liable to his customer. It has been held that the reasonable time would be presenting the cheque within one day after the receipt thereof where the cheque is drawn on a bank in the same place, or forwarding or presenting it on the day following the receipt thereof where the cheque is drawn on a bank in another place. After the expiry of reasonable time, the customer paying in the cheque for collection is entitled to presume that it has been collected and the proceeds thereof credited to his account.

Conversion

According to Dictionary of Banking, "Conversion is a legal term signifying wrongful interference with another person's property inconsistent with another's right of possession." Conversion applies only to tangible property and not to debts. Negotiable Instruments are included in the term 'property'. The collecting banker may be charged for conversion if he collects a cheque for a customer having defective title to it. The collecting banker while collecting the payment of a cheque to which his customer has defective title, deprives the true owner of the cheque to receive payment. So he incurs a liability to the true owner of the cheque. The principle which is applied here is that a rightful owner of the cheque can recover the same from anyone who takes it without his authority and in whose hands it can be traced. But the banker has been granted statutory protection in certain circumstances which are discussed later.

In the following cases, the banker is liable for conversion to the true owner of the instrument:

(a) when he collects a cheque, a bill of exchange, or a promissory note bearing a forged endorsement or in respect of which the customer has no title at all;
(b) when he borrows for his customer the proceeds of a cheque on which the customer has no title or only defective title;
(c) when he takes as holder for value, a cheque marked 'not negotiable; and
(d) when he delivers to the wrong person the goods entrusted with him for safe-custody.

In the following cases, the banker is not liable for conversion to the true owner of a cheque:

(a) where there is no forgery and the instrument comes into the hands of the holder in due course; and
(b) where there is forgery and the instrument is a cheque, payment whereon has been made in due course by the banker.

Statutory Protection to Collecting Banker

Section 131 of the Negotiable Instruments Act provides protection to a collecting banker who receives payment of a crossed cheque or draft on behalf of his customers. According to Section 131 of the Act "a banker who has, in good faith and without negligence, received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment."

The protection provided by Section 131 is not absolute but qualified. A collecting banker can claim protection against conversion if the following conditions are fulfilled.

1. **Good Faith and Without Negligence:** Statutory protection is available to a collecting banker when he receives payment in good faith and without negligence.

The phrase in "good faith" means honestly and without notice or interest of deceit or fraud and does necessarily require carefulness. Negligence means failure to exercise reasonable care. It is not for the customer or the true owner to prove negligence on the part of the banker. The burden of proving that he collected in good faith and without negligence is on the banker. The banker should have exercised reasonable care and deligence. What constitutes negligence depends upon facts of each case. Following are a few examples which constitute negligence:

(a) Failure to obtain reference for a new customer at the time of opening the account.

(b) Collection of cheques payable to 'trust accounts' for crediting to personal accounts of a trustee.

(c) Collecting for the private accounts of partners, cheques payable to the partnership firms.

(d) Omission to verify the correctness of endorsements on cheques payable to order.

(e) Failure to pay attention to the crossing particularly the "not negotiable crossing."

2. **Collection for a Customer:** Statutory protection is available to a collecting banker if he collects on behalf of his customer only. If he collects for a stranger or non-customer, he does not get such protection. As Jones aptly puts if "duly crossed cheques are only protected in their collection, if handled for the customer." A bank cannot get protection when he collects a cheque as holder for value. In Great Western Railway Vs London and Country Bank it was held that "the bank is entitled for protection as it received collection for an employee of the customer and not for the customer."

3. **Acts as an Agent:** A collecting banker must act as an agent of the customer in order to get protection. He must receive the payment as an agent of the customer and not as a holder under independent title. The banker as a holder for value is not competent to claim protection from liability in conversion. In case of forgery, the holder for value is liable to the true owner of the cheque.

4. **Crossed Cheques:** Statutory protection is available only in case of crossed cheques. It is not available in case uncrossed or open cheques because there is no need to collect them through a banker. Cheques, therefore, must be crossed prior to their presentment to the collecting banker for clearance. In other words, the crossing must have been made before it reached the hands of the banker for collection. If the cheque is crossed after it is received by the banker, protection is not available. Even drafts are covered by this protection.

To conclude, it is necessary that the collecting banker should have acted without negligence if he wants to claim statutory protection under Section 131 of the said Act. The statutory protection is available to the banker if he collects a cheque marked "Not Negotiable"

for a customer, whose name is not used as the payee there-in provided the requirements of the said sections are duly complied with.

Duties and Responsibilities of a Collecting Banker

The duties and responsibilities of a collecting banker are discussed below:

1. Due care and diligence in the collection of cheque.
2. Serving notice of dishonour.
3. Agent for collection.
4. Remittance of proceeds to the customer.
5. Collection of bill of exchange.

1. **Due Care and Diligence in the Collection of Cheques:** The collecting banker is bound to show due care and diligence in the collection of cheques presented to him. In case a cheque is entrusted with the banker for collection, he is expected to show it to the drawee banker within a reasonable time. According to Section 84 of the Negotiable Instruments Act, 1881, "Whereas a cheque is not presented for payment within a reasonable time of its issue, and the drawer or person in whose account it is drawn had the right, at the time when presentment ought to have been made, as between himself and the banker, to have the cheque paid and suffers actual damage, through the delay, he is discharged to the extent of such damage, that is to say, to the extent to which such drawer or person is a creditor of the banker to a large amount than he would have been if such cheque had been paid."

   In case a collecting banker does not present the cheque for collection through proper channel within a reasonable time, the customer may suffer loss. In case the collecting banker and the paying banker are in the same bank or where the collecting branch is also the drawee branch, in such a case the collecting banker should present the cheque by the next day. In case the cheque is drawn on a bank in another place, it should be presented on the day after receipt.
2. **Serving Notice of Dishonour:** When the cheque is dishonoured, the collecting banker is bound to give notice of the same to his customer within a reasonable time. It may be noted here, when a cheque is returned for confirmation of endorsement, notice must be sent to his customer. If he fails to give such a notice, the collecting banker will be liable to the customer for any loss that the customer may have suffered on account of such failure.

   Whereas a cheque is returned by the drawee banker for confirmation of endorsement, it is not called dishonour. But in such a case, notice must be given to the customer. In the absence of such a notice, if the cheque is returned for the second time and the customer suffers a loss, the collecting banker will be liable for the loss.
3. **Agent for Collection:** In case a cheque is drawn on a place where the banker is not a member of the 'clearing-house', he may employ another banker who is a member of the clearing-house for the purpose of collecting the cheque. In such a case the banker

becomes a substituted agent. According to Section 194 of the Indian Contract Act, 1872, "Whereas an agent, holding an express or implied authority to name another person to act in the business of the agency has accordingly named another person, such a person is a substituted agent. Such an agent shall be taken as the agent of a principal for such part of the work as is entrusted to him."

4. **Remittance of Proceeds to the Customer:** In case a collecting banker has realised the cheque, he should pay the proceeds to the customer as per his (customer's) direction. Generally, the amount is credited to the account of the customer on the customer's request in writing, the proceeds may be remitted to him by a demand draft. In such circumstances, if the customer gives instructions to his banker, the draft may be forwarded. By doing so, the relationship between principal and agent comes to an end and the new relationship between debtor and creditor will begin.
5. **Collection of Bills of Exchange:** There is no legal obligation for a banker to collect the bills of exchange for its customer. But, generally, bank gives such facility to its customers. In collection of bills, a banker should examine the title of the depositor as the statutory protection under Section 131 of the Negotiable Instruments Act, 1881. Thus, the collecting banker must examine very carefully the title of his customer towards the bill. In case a new customer comes, the banker should extend this facility to him with a trusted reference.

From the above discussion, there is no doubt to say that the banker is acting as a mere agent for collection and not in the capacity of a banker. If the customer allows his banker to use the collecting money for its own purpose at present and to repay an equivalent amount on a fixed date in future the contract between the banker and the customer will come to an end.

Marking of Cheque

The marking of cheque means "a cheque which is marked or certified by the drawee banker, to the effect, that it is good for payment." The drawee bank certifies that the drawer of the cheque has sufficient balance in his account and the cheque will not be dishonoured due to lack of funds. Such a certificate is known as "Marking of Cheques."

Generally, the marking of a cheque is done by drawee in writing the words "good for payment" across one corner of the cheque, with the signature of the bank's authorised official and the bank's stamp. The marked cheques are very useful for businessmen as they can purchase the goods required by them, and the sellers will accept the marked cheques like currency-notes. It is to be noted here that marking post-dated cheques is not valid.

Who Can Get the Cheque Marked?

The marking of cheques may be done at the request of:

(a) the drawer
(b) the holder, and
(c) another banker.

These have been discussed below.

(a) **Marking at the Request of the Drawer:** Whereas a cheque is marked by the drawee bank at the request of the drawer, the latter cannot stop payment. In such case, the banker is bound to honour the cheque so marked by it. In case the drawer dies or becomes insane, the banker will have to make the payment because of the cheque having been marked at the request of the drawer. In such case, the banker has statutory protection in refusing other cheques of the customer if there are not sufficient funds in his account.

(b) **Marking at the Request of the Holder:** The marking of a cheque at the request of the holder or payee does not virtually place any liability on the paying banker. It simply means that at the time of marking, the drawee banker has sufficient funds to the credit of the drawer to meet the cheque. In such circumstances, there is no guarantee to the holder that the amount of the cheque will be paid to him when he presents it for payment. If a customer has sufficient funds in his account and he presents a cheque for payment, the banker will honour the cheque immediately.

(c) **Marking at the Request of Another Banker:** When a banker marks a cheque at the request of another banker for clearance purposes, the paying banker is undertaking an obligation to honour it. In actual practice, marking a cheque for clearance purposes entitles the paying banker to earmark the necessary funds to meet the cheque. Sir John Paget expressed his views, "Such marking constitutes a constructive payment or appropriation to a specific person though not directly indicated by the customer."

For the significance of marking of cheque, it is necessary that the sufficient balance of money must be on credit with the drawer on that particular date. It is, however, made clear by the following illustration:

A cheque drawn on Canara Bank on 21st February, 1987 post-dated to 26th February, 1987, was certified by the Manager of the Bank "Good for Payment on 26th February, 1987." State Bank of India became holder of the cheque in due course, which when presented for payment on 26th February, 1987, was dishonoured on account of lack of funds. In such a case, Canara Bank would not be liable for the cheque.

In short, the practice of marking of cheques at present, has been stopped in India on account of inter-bank agreement.

Conclusion

From the above discussion, there is no doubt to say that, a banker who acts as a collecting banker has certain duties and liabilities, and he is bound to use reasonable care and skill while collecting cheques and other negotiable instruments. Dr. D.L. Hart has observed in connection with the duties of a collecting banker, that, as his customer's agent in the matter, the banker is bound to use reasonable skill, care and diligence in presenting and securing payment of the drafts entrusted to him for collection and placing the proceeds to his customer's account, or in taking such other steps as may be proper to secure the customer's interests.

Questions for Discussion

1. Explain the term “collecting banker.” What are his duties and responsibilities in the collection of his customer’s cheques?
2. Discuss the position of a collecting banker as:
   (a) A holder for value.
   (b) An agent of his customer.
3. Explain the nature of protection given to the collecting banker under the Negotiable Instruments Act.
4. Give note on the term “Conversion.”
5. What is meant by marking of cheques? Bring out the significance of marking with regard to the following:
   (a) Request of the drawer
   (b) Request of the holder, and
   (c) Request of another banker.

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LOANS AND ADVANCES

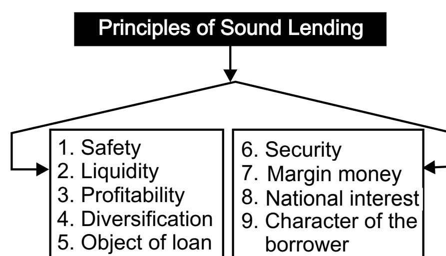
INTRODUCTION

One of the primary functions of a bank is to grant loans. Whatever money the bank receives by way of deposits, it lends a major part of it to its customers by way of loans, advances, cash credit and overdraft. Interest received on such loans and advances is the major source of its income. The banks make a major contribution to the economic development of the country by granting loans to the industrial and agricultural sectors.

The banks make loans and advances out of deposits, received from their customers. Most of these deposits are payable on demand. As such the bank owes a greater responsibility to the depositors. Hence he should be extremely careful while granting loans.

General Rules of Sound Lending

A banker should use his third eye and third ear (although the God has given him only two eyes and two ears) while granting loans. In other words, he must be extra careful while granting loans. A banker should take the following precautions:



These are discussed below.

1. **Safety:** The most important golden rule for granting loans is the safety of funds. The main reason for this is that the very existence of the bank is dependent upon the loans granted by him. In case the bank does not get back the loans granted by it, it might fail. A bank cannot and must not sacrifice the safety of its funds to get higher rate of interest. For example, if a reputed credit-worthy businessman offers to pay 10 % interest per annum and on the other hand a pauper offers 15 % rate of interest per annum. Obviously as per safety rule, the banker should not grant loan to the pauper although paying 5 % higher rate of interest.
2. **Liquidity:** The second important golden rule of granting loan is liquidity. Liquidity means possibility of converting loans into cash without loss of time and money. Needless to say, that the funds with the bank out of which he lends money are payable on demand or short notice. As such a bank cannot afford to block its funds for a long time. Hence the bank should lend only for short-term requirements like working capital. The bank cannot and should not lend for long-term requirements, like fixed capital.
3. **Return or Profitability:** Return or porfitability is another important principle. The funds of the bank should be invested to earn highest return, so that it may pay a reasonable rate of interest to its customers on their deposits, reasonably good salaries to its employees and a good return to its shareholders. However, a bank should not sacrifice either safety or liquidity to earn a high rate of interest. Of course, if safety and liquidity in a particular case are equal, the banker should lend its funds to a person who offers higher rate of interest.
4. **Diversification:** 'One should not put all his eggs in one basket' is an old proverb which very clearly explains this principle. A bank should not invest all its funds in one industry. In case that industry fails, the banker will not be able to recover his loans. Hence, the bank may also fail. According to the principle of diversification, the bank should diversify its investments in different industries and should give loans to different borrowers in one industry. It is less probable that all the borrowers and industries will fail at one and the same time.
5. **Object of Loan:** A banker should thoroughly examine the object for which his client is taking loans. This will enable the bank to assess the safety and liquidity of its investment. A banker should not grant loan for unproductive purposes or to buy fixed asset. The bank may grant loan to meet working capital requirements. However, after nationalisation of banks, the banks have started granting loans to meet loan-term requirements. As per prudent banking policy, it is not desirable because of term lending by banks a large number of banks had failed in Germany.
6. **Security:** A banker should grant secured loans only. In case the borrower fails to return the loan, the banker may recover his loan after realising the security. In case of unsecured loans, the chances of bad debts will be very high. However, the bank may have to relax the condition of security in order to comply with the economic

policy of the government. For example, loans to weaker sections of society may be given without security if so directed by the government.

7. **Margin Money:** In case of secured loans, the bank should carefully examine and value the security. There should be sufficient margin between the amount of loan and the value of the security. If adequate margin is not maintained, the loan might become unsecured in case the borrower fails to pay the interest and return the loan. The amount of loan, should not exceed 60 to 70 % of the value of the security. If the value of the security is falling, the bank should demand further security without delay. In case he fails to do so, the loan might become unsecured and the bank may have to suffer loss on account of bad debt.
8. **National Interest:** Banks were nationalised in India to have social control over them. As such, they are required to invest a certain percentage of loans and advances in priority sectors viz., agriculture, small scale and tiny sector, and export-oriented industries etc. Again, the Reserve Bank also gives directives in this respect to the scheduled banks from time to time. The banks are under obligations to comply with those directives.
9. **Character of the Borrower:** Last but not the least, the bank should carefully examine the character of the borrower. Character implies honesty, integrity, credit-worthiness and capacity of the borrower to return the loan. In case he fails to verify the character of the borrower, the loans and advances might become bad debts for the bank.

The above are thus the basic principles of sound lending observed by commercial banks. The ways in which the basic principles are followed, of course, may be modified to suit the need of the hour.

Forms of Lending (Advances)

Banks lend for working capital requirements in the form of:

1. Loans
2. Cash credit
3. Overdraft
4. Purchase and discounting of bills of exchange.

1. **Loans:** This is the oldest and very popular form of lending by the banks. In case of loans, financial assistance is given for a specific purpose and for a fixed period. The customer can withdraw the entire amount of loan in a single instalment. As such, interest is payable on the entire amount. In case he needs the funds again, he has to make a fresh application for a new loan or renewal of the existing one. Ordinarily, the loans is repayable in one instalment. However, a customer may return the loan in more than one instalment also.

Merits of Granting Loans

A. Simplicity

The method is very simple. Interest is payable on the entire amount of the loan.

B. Better Recovery of Interest and Loan

The customer knows in advance the time of return of the loan. Therefore, he makes arrangement for its return. In case he does not return the loan in time, the bank will not grant loans and advances to him in future. It acts as an automatic regulator to discipline the borrower.

C. Profitability

From the point of view of the bank, the method is economical. The customer has to pay interest on the entire amount of the loan even if he has not withdrawn the entire loan. To that extent funds can be used by the bank.

Demerits

A. Inflexibility

The method is simple but inflexible. Borrower has to make a fresh request for the loan every time he requires the loan.

B. Overborrowing

Since the loan method is inflexible a customer takes a loan in excess of his needs to meet any contingency. This results in overborrowing.

C. More Formalities

As compared to cash credit and overdraft methods, loan documentation is more complicated.

2. **Cash Credit:** Cash credit is the most popular method of lending by the banks in India. It accounts for more than two third of total bank credit. Under cash credit system, a limit, called the credit limit is specified by the bank. A borrower is entitled to borrow upto that limit. It is granted against the security of tangible assets or guarantee. The borrower can withdraw money, any number of times upto that limit. He can also deposit any amount of surplus funds with him from time to time. He is charged interest on the actual amount withdrawn and for the period such amount is drawn.

   Commitment Charges: To discourage the borrower from keeping large funds idle within the sanctioned limit bank levies commitment charges. This also helps the bank in two ways. Firstly, it compensates him for the loss on idle funds kept by him within the credit limit sanctioned. Secondly, it facilitates better credit funds management. It will be applicable to borrower having a working capital limit of Rs. one crore or more. The rate of commitment charges is 1% per annum on the unutilised portion of cash credit limit sanctioned. However, no such charges will be levied, if the unutilised quarterly operating limit is upto 15%.

Again, it will not be applicable to sick units, export credit or export incentives, inland bills and credit limits granted to commercial banks, cooperative banks and financial institutions.

Merits of Cash Credit

A. Flexibility

The greatest advantage of cash credit method is that it is flexible. A customer can withdraw and deposit money any number of times.

B. Economical

The scheme is economical. A borrower has to pay interest only on the amount borrowed and that too for the period the amount is actually withdrawn. Unlike a loan he is not required to pay interest on the entire amounts of the loan.

C. Less Formalities

As compared to the loan method, there are less formalities, and frequent documentation is avoided. Moreover, documentation in this method is less complicated.

Demerits

Cash credit method is not without demerits.

A. Over Borrowing

Credit limits are fixed one in a year. It gives rise to the tendency of fixing higher limits to cover contingencies. Thus it encourages over-borrowing.

B. Division of Funds

The bank has control over the amount of credit sanctioned. It does not have any control over the use of such funds. Consequently the borrower diverts the funds, without the knowledge of the bank, for unapproved purposes.

C. Non-utilisation of Funds

In practice a large amount of sanctioned cash credit limit remains unutilised. Levy of commitment charges has failed to put an end to this weakness because it is levied on cash credit limit of Rs. one crore or more.

3. **Overdraft:** One of the main advantages of a current account is that, its holder can avail of the facility of overdraft. An overdraft facility is granted to a customer on a written request. Sometimes, it may be implied where a customer overdraws his account and the bank honours his cheques. [Bank of Maharashtra Vs M/s United Construction Co. and Others (1985) Bom. 432 A.I.R.]

   The bank should obtain a written request from the customer. He should also settle the terms and conditions and the rate of interest chargeable. It is usual to obtain a promissory note from the customer to cover the overdraft.

Distinction between Loan and Cash Credit

(a) ***Amount:*** In case of loan a fixed amount is sanctioned, whereas in case of cash credit a limit is fixed.

(b) ***Period:*** Loan can be granted for a short, medium and long-term but cash credit is granted only for a short period upto one year only.

(c) ***Withdrawal:*** The entire amount of loan is credited to the customer's account. In case of cash credit the customer can withdraw the amount upto the limit when he needs.

(d) ***Interest:*** In case of loan, interest is payable on the entire loan, whereas in case of cash credit, interest is payable only on the amount actually withdrawn and for the period the amount is withdrawn.

(e) ***Repayment:*** Ordinarily a loan is repayable in one lump sum. However, it may be paid in instalments also. On the other hand in case of cash credit, the borrower may repay any surplus amount from time to time.

Distinction between Cash Credit and Overdraft

Ordinarily, in practice no distinction is made between cash credit and overdraft. The reason is that their purpose and nature is almost the same. Inspite of this there are the following points of distinction between them:

(a) ***Period:*** The main difference between cash credit and overdraft is that the former is granted comparatively, for a longer period, whereas overdraft is a temporary facility.

(b) ***Opening Separate Account:*** For granting cash credit it is necessary to open a new account. No new account is necessary for overdraft.

(c) ***Current Account:*** Overdraft facility is granted to a current account holder only. It is not necessary to be a current account holder, to avail of the facility of cash credit.

(d) ***Control of Central Government:*** The Central Government exercises strict control over cash credit. There is no such control on overdraft.

(e) ***Commitment Charges:*** In case of under-utilisation of cash credit a customer has to pay commitment charges. No commitment charges are payable in case of overdraft.

(f) ***Form of Security:*** Cash credit is ordinarily granted on the security of goods by way of pledge or hypothecation. Overdraft is granted on the personal security of the borrower or financial securities viz., shares, bonds etc.

4. **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 discounting 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 discounted, the amount will be recovered from the customer.

Types of Loans and Advances

Loans and advances are of different types. These can mainly be classified on the following bases:

A. On the Basis of Object or Purpose

For which purpose a loan is being taken? It may be for the following purposes:

(a) ***Commercial Loans:*** This loan is taken to meet short term requirement of capital e.g., working capital.

(b) ***Consumer Loan:*** This loan is taken to finance household goods like fridge, T.V., scooter etc.

(c) ***Agricultural Loan:*** Such a loan is taken by the farmers to meet their short term requirements like buying seeds, fertilisers, insecticides etc.

B. On the Basis of Time

(a) ***Short Term Loan:*** Such a loan is taken for a period of less than one year. For example, to meet working capital requirements.

(b) ***Medium Term Loan:*** Such a loan is taken for a period ranging from 1 year to 3 years. For example, to purchase equipments for professionals or furniture etc.

(c) ***Long Term Loan:*** Such a loan is taken to meet long-term requirements from 3 years to 20 years or more. For example, loans to purchase land, building, plant and machinery etc. However, banks provide long-term loans to a very limited extent only.

C. On the Basis of Security

(a) ***Secured Loan:*** Such a loan is granted on the security of tangible assets, Sec. 5 (a) of the Banking Regulation Act, 1949, defines a 'secured loan or advance' as 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.

(b) ***Unsecured Loans:*** Such a loan is granted without any security. According to Sec. 5 (a) of the above Act an unsecured loan or advance means a loan or advance not so secured.

D. On the Basis of Form

(i) Loan,

(ii) Cash credit, and

(iii) Overdraft.

These have already been discussed earlier in detail. As such these are not being discussed again.

Determining Creditworthiness

A banker has to be very careful while granting loans. There is a greater risk in unsecured loans. Even in the case of secured loans, the banker should carefully examine the creditworthiness of the borrower. The following factors should be kept in mind while determining the creditworthiness of the borrower:

(a) ***Character:*** The most important factor to be carefully examined, is the character of the borrower. Character is the sum total of honesty, integrity, credit-worthiness, capacity to repay, sense of responsibility, good habits and reputation enjoyed by the customer. If he possesses these qualities he bears a good character and can be considered creditworthy for the loan.

(b) ***Ability to Run the Enterprise:*** If the borrower is fully capable of running the enterprise and has necessary skill and experience, his chances of success are high. As such there is little or no risk in granting loans.

(c) ***Adequate Capital:*** An entrepreneur should have an adequate capital of his own. If his capital is inadequate there are greater chances of failure of his business. As such, the banker will not be able to recover his loan in such a situation.

(d) ***Soundness of the Project:*** The banker should carefully examine the project report to ascertain its viability and soundness. If the project is sound and viable the banker will be able to recover his debt. On the other hand, if the project is unsound the project will fail. The banker will not be able to recover his loan.

Sources of Credit Information

A banker needs credit information about a customer, his enterprise, industry etc., in order to assess his creditworthiness. He should cross check the information collected by him from different sources. In India there are no specialised agencies which can provide the necessary information. In western countries there are specialised agencies which supply credit information. However, a beginning has been made by the Reserve Bank of India in the field of credit information collection by establishing a Credit Information Bureau. Therefore, the banks have to make their own arrangement for collecting credit information. Credit information can be collected from the following sources:

1. **The Borrower:** The starting point is the borrower himself. He is asked to fill up an application form. The form should be carefully devised to elicit full information from the customer. The form should be as detailed as possible. Besides, his account books, pass book and references from his friends and relations should be carefully examined and cross checked.
2. **Credit Information Bureau:** As pointed out earlier the Reserve Bank has established a Credit Information Bureau. The Reserve Bank is empowered to collect credit information from the banks under Section 45-C (i) of the Reserve Bank of

India Act, 1934. Such credit information is collected in respect of credit limit of Rs. 5 lakhs and over in case of secured advances. Such limit for unsecured advances is Rs. one lakh. This information is available in consolidated form specifying nature of facility, security, charge and outstanding balance.

The information will enable the bank to know the extent of borrowing by the applicant. However, this information is of little or no use. It is available in respect of big customers only and is very scanty.

3. **Exchange of Credit Information:** This is the most important source of credit information and is based on the customary usage and practice prevalent in the banking industry. However, exchange of credit information amongst banks is of limited use. Because of fear of loosing legal protection, banks are reluctant to exchange free and fair credit information. The Reserve Bank of India (Amendment) Act, 1974 has granted statutory protection to exchange freely credit information by the banks amongst themselves. Moreover, the scope of the term 'credit information' has been enlarged to include information relating to the means, antecedents, history of financial transactions and the creditworthiness of the borrower.
4. **Enquiries From Traders and Businessmen in the Same Trade:** Credit information can be collected through enquiries made, from the fellow businessmen and traders. However, these too will be of limited use. A businessman will be reluctant to give fair and frank credit information about his fellow trader or businessman. However, such information may be useful, if it is cross-checked.

Conclusion

From the above discussion, the government, the banks and all concerned should seriously consider the situation and necessary steps should be taken before granting loans and advances. The bank dues should be treated at par with any other government dues. Every bank manager should be given adequate powers to take possession of the securities before the borrower has any chance to dispose of the same. The general feeling that one need not repay the bank loan and can get away with it should be erased from the minds of the people.

Questions for Discussion

1. Explain the golden (general) rules of sound lending by the banks.
2. Explain the various forms of lending by the banks.
3. How would you determine the creditworthiness of a borrower?
4. Explain the various sources of credit information. How far Credit Information Bureau is helpful in this respect?

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TYPES OF SECURITIES

INTRODUCTION

A security is a document that is an evidence of specific claims on a stream of income and/or the particular assets. Debt securities include bonds and mortgages. Ownership securities include common stock certificates and the title to marketable assets. In addition, preferred stock is a hybrid security which entitles its owner to a mixture of both ownership and creditorship privileges.

In this chapter it is proposed to deal with the precautions to be taken by a banker while granting loans against various types of securities.

Characteristics of Good Security

A good security should have the following characteristics:

1. Free from encumbrances
2. Easy marketability
3. Easy storability
4. Durability
5. Free from price fluctuations
6. Easy ascertainment of value
7. Earning of income
8. Free from heavy cost of handling
9. Free from disabilities

These are discussed below:

1. **Free from Encumbrances:** The security must be completely free from prior charges. If the borrower's title is defective, the banker cannot obtain a better title.

2. **Easy Marketability:** The security offered must be such that, it is easily marketable without loss in its value. In other words, it must possess the quality of liquidity.
3. **Easy Storability:** The securities should not pose a problem of storage to a banker. For example, certain goods like timbers, inflammable articles etc., require huge and special storage, which are costly. But some securities like, documents of title to goods, shares, consumer goods etc., can be stored without much difficulties.
4. **Durability:** A good security must possess the quality of durability. Perishable goods cannot be stored for long. So, they are not accepted as good banking securities. Durable goods alone can be stored for a reasonable period. So they are accepted as good banking securities.
5. **Free from Price Fluctuations:** An ideal security is one which is free from wide price fluctuations. When the price of the security falls suddenly, the value of the security becomes lesser than the amount of the loan granted. Hence, there arises a necessity of demanding further securities, or reducing the amount of the loan already sanctioned. It involves additional burden on the part of the banker.
6. **Easy Ascertainment of Value:** The security must be capable of being valued without much difficulties. In the case of gold, silver, stock exchange securities, consumer goods, etc., daily market reports are available. So their valuation is not difficult.
7. **Earning of Income:** A good security must be capable of earning income. Such incomes can be appropriated towards the loan amount. For instance, stocks and shares of well established companies earn a steady dividend. Such securities are preferable to a banker.
8. **Free from Heavy Cost of Handling:** The securities should not involve much handling cost. Bulky materials, which are difficult to store and expensive to handle should not be accepted by a banker.
9. **Free from Disabilities:** Certain securities have some inherent defects in them. For example, partly paid-up shares, a life insurance policy without admission of age, etc., are crippled with certain disabilities. So a banker should avoid such securities.

General Principles of Secured Advances

The following are the general principles or precautions which a banker should observe while granting advances against securities:

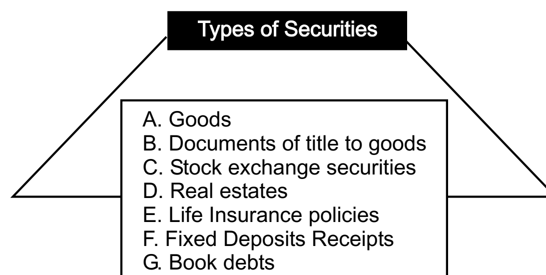
1. **Validity of the Title of the Borrower:** First of all, the banker must ascertain whether the borrower has a good title to the security. If he is satisfied with the title of the borrower, he must then get the title transferred to him by executing the necessary documents. In any case, a banker cannot obtain a better title than the borrower.
2. **Nature of the Security:** The banker should pay attention to the nature of the security. He must see whether the security possess all the qualities of a good security. A good security must be durable, storable and easily realisable in the market.

3. **Free from Defects:** In the case of secured advances, a banker relies more on the security rather than the credit worthiness of the borrower. Hence, the banker should see that these securities are completely free from defects.
4. **Documentation:** Documentation is an important step in bank lending. The bank should see that proper documents, such as mortgage deed or pledge or hypothecation arrangement containing all the terms and conditions of the charge are executed. This should be done in order to avoid all future disputes. The documentation procedure differs from bank to bank. Documentation is noting but the process of putting down the terms and conditions of the loan sanctioned in writing.
5. **Adequate Margin:** "Margin" means the excess of the market value of the security over the advance granted against it. The percentage of margin differs from one security to another. A banker must keep adequate margin while granting loans and advances because of the following reasons.
   (a) The market value of the security is subject to fluctuations. In case of a fall in the value of the security, the interests of the bank are safe if there is an adequate margin.
   (b) The loan amount is going on increasing year after year, since the interest is added to it. But the value of security may remain the same or if may even come down. If the value of security falls, a part of the security becomes unsecured automatically. Hence, adequate margin is needed.
   (c) In case of commodities which are subject to Reserve Bank's selective controls, the banker has to keep margin in accordance with the directions of the Reserve Bank.

From the above discussion, undoubtedly, we can say that all the above principles are very important. But let it not be forgotten that the principles of banking are very dynamic and the banker has to frame his policy in such a way as to suit credit requirements of the economic system of the country.

Types of Securities on which Loans or Advances can be Granted

The following are the important types of securities against which loans or advances are generally granted:



A. Advances Against Goods

Banks lend a large part of their funds on the security of goods. The goods may be agricultural products like paddy, rice, wheat, cotton, oil-seeds and raw-jute. They may be manufactured goods like cloth and sugar. They include minerals also. Advances against goods are mainly granted for working capital requirements of business and industries. Lord Chorley remarks that "advances against security of goods are a usual and proper form of banking business." The bankers in India are increasingly lending against goods. Goods are accepted as security by pledge or hypothecation.

Advantages

Goods, as security, are popular among bankers because of their merits. The following are the merits of goods as securities against bank advances:

1. **Tangible Security:** Goods are tangible securities, and so, they are better than guarantees. They can be sold in the market, when the borrower makes a default.
2. **Easy Realisability:** Most of the goods like rice, wheat, sugar, etc., are the necessities of life. So, there is always a ready market for them. Hence, they can be easily disposed off in the market, if the borrower makes any default.
3. **Easy Ascertainment of Prices:** The prices of goods can be known very easily because daily market reports are published in papers, or announced through radio and television.
4. **No Price Fluctuations:** The price of most of the goods are more or less steady.
5. **Short-period Advances:** Advances against goods are always given for short-periods, because most of the goods cannot be stored for a long-period. So, goods satisfy the cannon of liquidity.
6. **Easy to Create a Charge:** A charge over goods can be created very easily and with minimum formalities. It does not require any registration of documents, payment of stamp duty, etc., as in the case of real estate.
7. **Promotes Commerce:** Banks promote the development of trade, both internal and international, by lending against goods. Thus they help the people to get necessities of life easily and cheaply. Such advances will be the source of strength, stimulation and stability to trade and industry.

Drawbacks or Demerits

Goods are safe, sound and dependable securities for a banker. But they are not without risks or demerits. The following are the demerits of goods as securities:

1. **Risk of Deterioration:** Most of the goods are liable to deterioration and damage unless they are properly stored. The quality of some goods will be affected if stored for a long time. For example, fruits and vegetables perish within a short-time. Goods like rice and wheat also lose weight due to evaporation. The colour of cotton will change if stored for a long time. Moisture affects sugar and jaggery damages to goods by rats, ants, climatic variations cannot be ignored. As a result, the value of security falls with the passage of time.

2. **Risk of Fraud:** There are greater risks of fraud as regards to quantity and quality. Goods of good quality may be mixed up with inferior quality. Again, the contents of packages or bags alleged to contain certain goods may not contain such goods. Moreover, there is a possibility for shortage of goods in each bag. It is humanly impossible for a banker to check each and every bag.
3. **Risk of Price Fluctuations:** The prices of some goods fluctuate widely. For example, the prices of luxury goods may fall considerably if they go out of fashion. Industrial goods also subject to very heavy price fluctuations. Bankers are generally reluctant to accept the goods or commodities the prices of which are uncertain and fluctuate too widely and frequently.
4. **Risk of Storage and Verification:** The banker is in absolute control of godowns to store the goods, which have been pledged to secure a loan. There are no public warehouses in most of the towns. So the goods given as security have to be kept generally in the godowns of the borrower. The borrower may remove the goods given as security without the knowledge of the banker. Dishonest borrowers may cheat the bank. It is a problem for the banker to verify the physical existence of goods from time to time.
5. **Risk of Prior Charge:** Prior charge may exist in respect of the same goods. In such a case, the banker will lose his security. For example, the godown keeper may enjoy a prior lien over the goods in his godown in respect of the godown charges due to him.
6. **Heavy Transport Cost:** When the borrower makes a default, these goods have to be brought to the market for sale. It involves transportation of goods. The transport cost is always high in India.
7. **Valuation Difficult:** A banker must have good knowledge of market conditions of various goods. Besides, he must be able to distinguish between various varieties. Otherwise, valuation becomes difficult.

Precautions to be Taken by the Bankers

In view of the above drawbacks or demerits, a banker should be very cautious while granting advances against goods. He should take the following precautions:

1. **Character of the Borrower:** The banker should take into account the honesty, integrity and trustworthiness of the borrower. It is so because, a man of good character will not indulge in fraudulent activities like adulteration, use of false weights, measures etc.
2. **Experience in the Business:** The banker should also find out whether the customer has sufficient experience in the particular trade in which he has engaged himself. Only experienced persons can know the risks involved in a business, and also the profitable areas of the business. It is always risky to deal with inexperienced persons.
3. **Title of the Borrower:** The banker should ascertain whether the borrower has a genuine title to the goods. This can be done by verifying the invoices or cash receipts.

4. **Purpose of the Loan:** The banker must enquire into the purpose for which the loan is required. The repayment of any loan depends upon the purpose for which it is required. If the loan is required for productive purposes or preparing the goods for resale, loan can be granted without any hesitation. On the other hand, if the loan is asked for speculation, black marketing and hoarding, a banker should refuse it.
5. **Proper Valuation of Goods:** Adequate care should be taken to value the goods. It is on the basis of valuation, margin is fixed. Hence, a banker can appoint even experts to value the goods. He should not be carried away by invoice prices, since they might be inflated. So, he should actually compare the prices quoted in the bill with the prices prevailing in the market.
6. **Nature of Goods:** The banker should pay special attention to the nature of goods as well. Some of the goods cannot be stored for long, since their quality is very much affected. Hence, a banker should prefer only those goods which are not subject to deterioration in quality and which are easily realisable.
7. **Proper Storage:** Necessary care should be taken to see that the pledged goods are properly stored. The banker should also see that proper steps are taken to prevent loss of goods on account of rats and white ants. Besides, he must ask the customer to insure the goods against loss by fire, theft, and all possible risks. He should maintain godown register and record the particulars of goods stored in the godown.
8. **Care in a Rented Godown:** If the goods are stored in a rented godown, the banker must establish his prior lien with the owner of the building by means of an agreement. Otherwise, the owner will have a prior lien over the goods in respect of the rent charges due.
9. **Take Possession of Goods:** The banker should take delivery of the goods before granting any loan. This delivery may be actual or constructive delivery. The banker should always deal with the owner of goods or agent in possession of goods. When it is possible or practicable to take possession of goods given as security, the banker must ask the customer to enter into a contract of hypothecation.
10. **Godown Keys:** The godown keys must be handled very carefully. On no account, they should be handed over to the customer. They should be kept in a strong room under dual control.
11. **Adequate Insurance:** All goods subject to a charge must be insured upto the full market value of the goods. They must be insured against all possible risks. The policy and the premium receipts should be kept by the bank.
12. **Periodical Inspection:** The godown should be inspected by the banker periodically. The quality and quantity of goods in stock must be tallied with the records maintained by both the banker and the customer. If there is any difference, the customer should be put into task.
13. **Strict Supervision Over the Release of Goods:** Sometimes, the borrowers may be allowed to repay the loan in instalments. In such a case, the banker should ensure that the goods released are only in proportion to the amount of loan repaid. Each release must be directly supervised by a responsible officer of the bank.

14. **Short-period Advances:** Loans against goods must be granted only for short-periods, because the value of goods is likely to fall due to deterioration in their quality.
15. **Bank's Name Board:** The godowns containing pledged goods must be locked by the bank's padlock. The bank's name board, reading "Goods pledged to ....Bank" should be affixed permanently outside the godown in a prominent place.
16. **Directives of Reserve Bank:** The Reserve Bank of India often issues directives prescribing margins on various goods. These margins and other stipulations prescribed by the Reserve Bank should be carefully followed by banks while lending against goods.

B. Advances Against Documents of Title to Goods

Documents, which in the ordinary course of trade, are regarded as proof of the possession or control of the goods are called "documents of title to goods." They authorises the possessor or holder to transfer or receive the goods represented by them. Thus, the documents of title actually represent goods. They can be transferred by mere delivery or by endorsement and delivery. The delivery of these documents actually amounts to a symbolic delivery of goods represented by them. Banks find it easy to deal with these documents than physically dealing with goods. Hence, these documents are very popular among banks. The following are the important documents of title to goods:

1. Bill of lading
2. Dock warrant
3. Warehouse keeper's certificate
4. Delivery order
5. Railway receipt and lorry receipt

1. **Bill of Lading:** A bill of lading is a document issued and signed by ship owners or captain of the ship, acknowledging that the goods mentioned in the bill have been duly received on board and undertaking to deliver the goods in the like order and condition to the consignee or his order or assignee. The goods will be delivered subject to the payment of freight and other charges specified in the bill of lading.

   A bill of lading can be transferred either by endorsement or delivery. The goods mentioned in the bill are to be delivered to the legal-holder. The bill of lading is a proof that the goods have been dispatched by the exporter. The importer cannot claim the goods without the production of the bill of lading.
2. **Dock Warrant:** It is a document issued by a dock company. The document describes the goods, acknowledges the receipt of them and undertakes to deliver them to the order of the depositor.
3. **Warehouse Keeper's Certificate:** It is a document given by a warehouse keeper, certifying that he holds certain goods described therein and awaits instruction for their disposal from the person to whom the certificate is addressed.

4. **Delivery Order:** It is a document addressed to the proprietors of the warehouse where the goods are lodged by the owner. It contains his instructions regarding delivery of goods.
5. **Railway Receipt:** A railway receipt is a document of title to goods issued by the railway authorities. It is also a document acknowledging the receipt of goods to be handed over to the payee or his order at the destination.

Merits

Banker advances loans to the customer on the security of documents of title to goods. These documents, as security, have all the advantages and disadvantages of goods as securities. The reason is that documents of title to goods are symbols of title to goods. The merits are as follows:

(a) These advances are better than guarantees. They have the backing of goods.
(b) The goods have ready and wide market.
(c) Determination of valuation is easy.
(d) Advances are mostly for shorter periods.
(e) The goods have stable prices.
(f) They can be easily disposed off in case of default of payment by the borrower.
(g) These are quasi-negotiable instruments. They can be transferred by mere endorsement and delivery.

Risks or Demerits

Granting of advances against documents of title involve the following risks:

(a) The documents of title to goods give greater scope to commit frauds. In case of goods, the banker can satisfy himself by examining the quality and quantity of the goods. But this is not possible when a document of title is accepted as a security.
(b) The documents of title to goods may be created by sending defective and rejected goods also. There are ample scope for dishonest and unscrupulous persons to indulge in fraudulent activities.
(c) There is scope for forgery of documents of the title to goods. The bankers cannot get any right of ownership to the goods covered by forged documents since the rule is "forgery conveys no title".
(d) There is scope to alter the contents in the documents of title to goods.
(e) The transport companies do not give guarantee about the contents of the bags or packages etc. There may be pilferages in transit.
(f) The unpaid seller has got the right to stop the goods in transit the borrower becomes insolvent before the goods are delivered. In such a case, the banker runs the risk of losing the goods.
(g) There is scope for deterioration or damage of the goods during transit or storage.
(h) In the case of some commodities, there is scope for fluctuation of prices especially in regard to luxury goods.

(i) Sometimes, it becomes difficult to determine the value of certain types of goods.
(j) Some railway receipts are negotiable. In such a case, if the borrower has the defective title, the banker gets no better title.
(k) The railway receipts do not give correct discription of the goods dispatched.
(l) There is a tendency among borrowers to deposit bogus railway receipts or lorry receipts with a view to defraud the banker.

Precautions

The banker has to take the following precautions while accepting the documents of title to goods as security.

1. **Integrity and Honesty of the Borrower:** The banker has to look to the honesty, integrity, capacity, character and credit worthiness of the borrower. The advances are to be made only to trusted and reliable borrowers.
2. **Certificate Regarding Packing:** The banker has to ask the customer to provide him with the certificate of packing in order to verify the quality and quantity of the goods-in-transit.
3. **Depositing of all Copies of Bill of Lading:** The banker has to ask the customer to deposit all the copies of bill of lading. Usually the importer is supplied with three copies of bill of lading. If all the copies are not taken over by the banker, the customer may frauduently take delivery of the goods from the shipping company or he may pledge the other copies with another bank by misrepresentation.
4. **Documents Without Onerous Conditions:** The banker should accept only those documents which do not increase the burden or responsibility. For example, the banker may have to pay heavy charges for securing release of goods if there is a qualification in taking the delivery of goods.
5. **Blank Endorsement:** The banker has to take blank endorsement on the document, otherwise, he is liable to pay all incidental charges of transport.
6. **Insurance:** The banker has to see that goods are insured to cover the risk of voyage or transport. The banker has to examine whether the insurance policy covers all the risks. Further, he can have an idea of the goods and the value of goods from the insurance policy.
7. **Trust Receipt:** The banker should not part with the documents until the arrangements are made to secure the loans. He cannot take delivery of goods from steamship company unless the documents are handed over to the customer. So when the bill of lading and other related documents are handed over to the importer (customer) in order to enable him to take delivery of goods, he must obtain a trust receipt from the importer (customer). By executing a trust receipt, the customer agrees to hold goods or sale proceeds of the goods in trust for the banker till the loan amount is rapid. If the customer fails to pay the loan amount, he will be held liable for criminal breach of trust.

8. **Clean Documents:** The banker should not sanction loans and advances against the documents containing objectionable remarks about packing. At the time of granting loans and advances, the banker should always sanctions loans against the clean documents only.
9. **Control:** In case the customer fails to get delivery of goods, the banker should take over the goods in its control, store them and later on dispose of them under the instructions of the customers.

   From the above discussion, it is made clear that the banker should take precautions carefully before lending money against the security of goods and documents of title to goods. If the banker does so, he will be able to avoid risks in transactions and also utilise his funds in productive purposes.

C. Advances Against Stock Exchange Securities

Shares and debentures which are regularly purchased and sold in the stock exchange may be accepted as security by the bank. A stock exchange is an organised market where securities are purchased and sold. The securities traded on the floor of a stock exchange include the following:

(a) Bonds issued by the Central and State Governments.
(b) Securities issued by semi-Government authorities like port trusts, electricity boards, improvement trusts, etc.; and
(c) Shares and debentures issued by the companies.

Merits of Advances Against Stock Exchange Securities

Banks made advances against the security of above mentioned securities. The following are the merits of stock exchange securities as cover for bank advances:

(a) **Better than Guarantee:** Stock exchange securities provide a better security than is provided by a contract of guarantee because securities, even though they are paper documents, are treated as tangible assets. In case of default by the borrower, the bank can sell the securities in the market to recover the loan.
(b) **Marketability:** Stock exchange securities have a wide and a ready market. They can be sold easily in the stock exchange because they are on the active list of the recognised stock exchange.
(c) **Liquidity:** Since securities are easily marketable, they are highly liquid. A bank can get cash by selling the securities. Moreover, if a bank does not want to sell the securities, especially the Government ones, it can get accommodation by pledging them with the Reserve Bank of India.
(d) **Steady Price:** In normal times, the fluctuation in the prices of popular stock exchange securities are less than the changes in the prices of commodities like cotton and oils. More particularly, the fluctuations in the prices of Government securities are very small. So, the banks can readily advance loans against the security of Government securities.

(e) **Income:** The stock exchange securities are not idle assets. They yield income by way of interest or dividend. The amount of income so received can be credited to the loan account of the borrower to reduce his indebtedness.

(f) **Convenience:** Advancing loans on the basis of stock exchange securities is convenient in many respects. Firstly, it is easy to know the market value of the securities because stock exchange quotations appear in every leading newspaper. Moreover, prices can be known over the phone from the stock exchange. Secondly, it is very easy to ascertain the title of the borrower to the relevant securities by writing to the issuing authority or body. Thirdly, it is easy to transfer stock exchange securities; and lastly it is easy to recover the loan by selling the security in the case of default.

(g) **Quick Release of Security:** The securities can be easily released on discharge of the loan. The securities can again be registered in the name of the borrower without much expenses and formalities.

Risks in Advancing Against Securities

The following are the demerits of stock exchange securities as security against advances:

(a) **Forfeiture of Securities:** If the bank makes advance against partly paid securities and gets them transferred in its name, it may be called upon to pay the remaining balance. If the customer does not pay the calls, the bank will have to pay the calls to avoid the forfeiture of securities.

(b) **Non-negotiability:** The stock exchange securities are generally not negotiable instruments. So the bank as a pledgee cannot get a better title than that of the pledger. However, in case of bearer securities, this risk will not be there.

(c) **Fluctuation in Prices:** The prices of certain securities, particularly shares and debentures of companies, fluctuate widely because of many factors. A bank will suffer loss if it does not keep sufficient margin and the price of a share or a debenture goes down considerably. Wide fluctuations in prices of the securities make them less liquid sometimes, because there are no purchasers and sellers of such securities in the stock exchange.

(d) **Company's Lien:** The articles of association of most of the companies contain a clause that the company will have a right of lien for the calls or any other amount due by the shareholders. The securities of such companies should not be accepted as security against loans.

(e) **Forged Certificates:** It is difficult for a bank to distinguish between a genuine share certificate and a forged one. If the bank advances loan against a forged certificate by mistake, it will incur a loss.

Precautions to be Taken in Advancing Against Securities

A bank should take the following precautions while making advances against stock exchange securities.

1. **Choice of Securities:** A bank cannot advance money blindly against each and every security because all the securities are not worth accepting. A bank should continuously examine the approved list of securities dealt with on the stock exchange. It must study the progress and working of various companies whose securities are dealt with on the stock exchange. It must study the audited balance sheets and profit and loss accounts of various companies and the constitution of their boards of directors. On the basis of the study, the bank should prepare a list of securities against which advances may be made. This list must be revised atleast after every quarter. This will reduce risk of making advances on undesirable stock exchange securities.
2. **Valuation of Securities:** If a customer offers a security against the advance which is in the approved list of the bank, the next step is the valuation of the security. The bank must ascertain the value of the shares and other securities with proper care. Securities cannot, generally, be taken at their face value. Market value is the deciding factor in this case. Generally, the prices of the shares are quoted cum dividend. Bank should deduct the dividend from the current market price. However, a bank should not rely completely on the stock exchange quotations. It should study the economic conditions of the country and the industry concerned. This will help to know the reasons if the price of the security is abnormally high or low.
3. **Adequate Margins:** The prices of some securities fluctuate widely because of various reasons. A bank should keep adequate margin while lending against the securities so that it may not suffer any loss when there is a heavy fall in the price of the concerned securities.
4. **Debentures and Preference Shares:** The bank should prefer preference shares and debentures to equity shares because the fluctuations in the prices of debentures and preference shares are small. Similarly, fluctuations in the market prices of the government and semi-government securities are small. So, they may be preferred by the banks.
5. **Partly-paid Securities:** When a security or share is offered to a bank, it should examine whether it is partly-paid or fully-paid. Bank should not take the unnecessary risk of advancing against partly-paid shares. Calls may be made against these shares by the company and if the customer fails in paying the calls, the shares are likely to be forfeited. However, if the customer is highly creditworthy, the bank may advance the loan to him against the partly-paid shares. In such a case, it is better to take an undertaking from the customer that he would pay the call, if made by the company.
6. **Transfer of Securities:** If the securities are bearer and negotiable, the bank can obtain the title by mere delivery. If the securities are registered one, the bank must get the transfer deed signed by the borrower. The bank's charge over the shares will be complete if shares are transferred in its name in the books of the company.

   When the loan is repaid, the bank may transfer back the shares to the customer. Alternatively, the bank may secure an equitable charge on the securities. In such a case, the bank should take a 'Memorandum of Deposit' from the customer to make

the equitable charge effective. The bank should also obtain a blank transfer deed duly signed by the customer. In case of default, the bank can fill in the transfer deed and get the securities registered in its own name and afterwards sell the securities to realise the loan.

7. **Notice to Company:** Whenever a bank makes an advance against shares or debentures, it must give a notice to the concerned company stating its interest in the shares deposited with it as security. This will prevent the issue of duplicate certificate by the company.

   In addition to the above mentioned precautions, the bank should not advance loan against its own shares as it is prohibited by Sec. 20 of the Banking Regulation Act. The sum total of advances against the stock exchange securities should not exceed 30 % of the paid-up capital of the banking company.

D. Advances Against Real Estate

By the term 'real estate' is meant all types of immovable properties including tangible assets like land, building etc. Generally, commercial banks do not favour granting of loans and advances against the security of real estates due to a number of risks and demerits. The commercial banks accept real estate as security in the exceptional cases only, i.e., if the customer has no security to offer except real estate.

Causes of Refusing Real Estate as Security

The commercial banks do not stand in a position to accept real estate as security for their advances on account of a number of difficulties or drawbacks. These difficulties are discussed below.

1. Customer's title.
2. Heavy expenses.
3. Valuation.
4. Legal formalities.
5. Loss of liquidity.
6. Delay in realisation.
7. Administration of properties.
8. Maintenance.

1. **Customer's Title:** While advancing loans against real estate, customer's title is the major problem. It is very difficult for the banker to find out the customer's interest in the property. When the customers offer property as security particularly in case of agricultural lands etc., the banker has to spend much more time and money to verify the title of the borrower on one side and on the other side, the property may be disputed one.
2. **Heavy Expenses:** Whereas the bank takes decision to grant loans and advances against the immovable security, the customer has to spend heavy amount in mortgaging the property. In such circumstances, the customer wants to take loan for a long period as legal mortgage is not only expensive but also inconvenient. It is to

be noted here that legal mortgage is not a good idea for the customer because it may put an additional burden upon him (customer).

3. **Valuation:** Another major problem is valuation of property before the bank. A banker can not rely on its own judgement for this purpose. The value of immovable property depends upon the type of construction, location etc. For such confirmations, the banks have to employ qualified valuers for the purpose.
4. **Legal Formalities:** While advancing against real estate or property, a number of legal formalities, such as preparation of the mortgage deed, its registration, payment of stamp duty etc., must be completed by the banker and the customer.
5. **Loss of Liquidity:** When the customers offer immovable property as security, they demand to take loan for a long period because they have to spend much of their time and money on the compliances of papers. In such case if the commercial banks grant loans and advances for a long period, these will affect their liquidity position since, if the customers do not repay loans and advances, it will be very difficult for the bankers to dispose off their immovable properties in the market.
6. **Delay in Realisation:** In case the mortgager is unable to repay the amount due from him, the banker has to undergo many formalities before the sale of the mortgaged property can be completed. Consequently, the banker has to wait for many months, because it is not possible for the customers to get back banker's moneys.
7. **Administration of Properties:** As the mortagagee of land and buildings, the banker may be required to administer the land and buildings and also collect rents and keep accounts.
8. **Maintenance:** In case the customer fails to repay the loan, the banker has to recover the loan by selling its mortgaged property. It is very difficult for the banker to look after the maintenance of the property.

Precautions in Advancing Against Real Estate

While lending money against the security of real estate, the banker should take the following precautions:

1. **Verification of Title:** While advancing money against the real estate as security, the banker should verify the title deeds of the customer very carefully. The banker should also examine the deed through its solicitors. It should be also necessary for the banker to verify if his borrower's property is disputed or not.
2. **Tenures of Land:** Before accepting real estate as security, the banker should see that the borrower's land must be freehold, leasehold or state-owned. In addition, there may be several changes in the land tenure frequently. While advancing loans, the banker should have knowledge regarding these changes because these are material facts for the bank.
3. **Expert Valuation:** The valuation of property is a very difficult task. Though the bank is not a valuer but where the loan is granted against real estate as security, the bank should entrust this difficult task to the expert valuers. The value of property depends upon the following:

(a) The location of the property.
(b) Ownership right.
(c) The rental value.
(d) The type of construction
(e) The size and structure of land.

4. **Margin:** While lending against the real estate, the banker should keep adequate margin. The banker should not grant loans and advances to the extent of more than 50 to 60 per cent of the real value of the borrower's property. For instance, where the value of the property is Rs. 5,000/-, the banker should grant loans and advances against the property for less than Rs. 3,000/-. By doing so, the banker may have to avoid involved risks.
5. **Insurance:** Before granting loans, the banker should examine that the properties of the borrowers are insured against fire and other calamities and the policy should be assigned in favour of the bank.
6. **Tax and Rent Payment:** Before accepting real estate as security the banker should obtain the receipt for the payment of house-tax and other taxes and must be kept along with title deeds. The banker should also see that all dues are regularly paid or not.
7. **Legal Mortgage:** According to Section 59 of the Transfer of Property Act, 1882, "Whereas the principal money secured is one hundred rupees or more, a mortgage other than a mortgage by deposit of title deeds (equitable mortgages) can be effected only by a registered instrument signed by the mortgager and attested by at least two witness." Whereas the borrower happens to be a joint stock company, all mortgages must be registered with the Registrar of Companies within 30 days of the date of their creation.
8. **Clearance of Income Tax:** Before accepting real estate as security, the banker should obtain a certificate from the borrower issued by Income Tax Office about the clearance of the property of the borrower. Under Section 230 A of the Income Tax-Act, 1961, registration of any property (other than agricultural land) is valued at more than Rs. 50,000/- is a must.

From the above discussion, it has been seen that making of advances on the security of real estate is not popular kind of business with commercial banks because commercial banks are not in a position to take their own judgement. These depend upon others both as regards the valuation of the immovable property offered as security as well as the title deeds of the person proposing to mortgage the same.

E. Advances Against Life Insurance Policies

A life insurance policy is accepted by bankers as a main security or as a supplementary security. Whereas the banker accepts life insurance policy as a main security, he advances between 85 to 90 per cent of its surrender value. But as a supplementary form, a life insurance policy is more useful because it is advisable to cover the signature by the life of the guaranter.

In India, life insurance business has been nationalised and it is being done by the Life Insurance Corporation of India (LIC). The Corporation has launched several types of insurance policies in the interest and nature of different customers. Some of these policies are the whole-life policy, money-back policy, joint life policy etc.

Merits of Life Insurance Policy as a Security

The life insurance policy is considered good as security due to the following causes:

1. **Guarantee of Payment:** The life insurance policy business is conducted by LIC of India which is a government undertaking and as such the payments, as and when due of all the policies are guaranteed. The risk will be minimised if the banker lends the money against the life insurance policy as security.
2. **Legally Assigned:** The policy can be legally assigned to the banker and such an assignment is duly registered with the Life Insurance Corporation. Thus, there is no risk in advancing against life insurance policies.
3. **Surrender Value:** The surrender value of a life insurance policy goes on increasing with the passage of time if the premium is regularly paid. In such circumstances, there is no risk in lending the money against such policy.
4. **Easy Supervision:** In case the banker advances money against the policy as security, the legal or general duty of a banker is always to keep an eye on the regular premium payments. By taking such steps the risk may be avoided.
5. **Self-liquidating:** In the even of the death of the borrower, the loan becomes self-liquidated in nature.

Demerits of Policies as Securities

The life insurance policy has not been very popular with bankers in India. J.W. Gilbert in his book, "Logic of Banking" observed: "A banker should never make any advances upon the life policies." The shortcoming or demerits of lending money against the life insurance policy are discussed below:

1. **Non-disclosure of Material Fact:** A contract of life insurance is a contract uberrimae fidei (utmost good faith.) The assured person is bound to make full disclosure of all the material facts within his knowledge to the insurer. In case, there is non-disclosure of any material fact by the assured it may enable there is the insurance company to avoid the claim under the policy. Further, if the assured is found guilty of fraud, the banker shall stand the risk of losing his money.

   Section 45 of the Insurance Act, 1938 states: "No insurance policy shall be disputed after it has been in force for two years from the date effecting the policy on the ground of any misrepresentation even as to a material fact, except where the misrepresentation alleged to have been made as to a material fact was knowingly made by the insured in order to defraud the insurance company."

2. **Risks in Case of Suicide:** The policies issued by the Life Insurance Corporation of India contain a 'suicide clause' stating that if the assured commits suicide within one year from the date of the policy, the security becomes null and void.
3. **Irregular Payment of Premia:** In case the insured fails to pay the premium regularly, the policy may be lapsed. The surrender value of a policy depends upon the class to which it belongs and the number of years it has been in force.
4. **Unsatisfactory Nature of Law:** In India, the bankers do not favour life policies as security for advances on account of unsatisfactory state of law relating to the question of assignment.

Precautions in Advancing Against LIC Policies

While accepting life insurance policies as security, the following precautions should be taken by bankers:

1. **Endowment Policy Favoured:** While lending money against life insurance policy as security, the banker should try to accept endowment policy to whole life policy as there is a definite maturity date in the case of the endownment class. But in the case of the whole-life policy the banker may have to wait for a long time, before the (Banker) may realise his advance from the policy-money.
2. **Admission of the Age:** Before loan is granted, the banker should examine carefully that the age of the insured has been duly admitted by the Life Insurance Corporation of India. The banker should also obtain a copy of the proof before loan is granted.
3. **Restriction of Assignment:** Before advancing money against the life insurance policy, the banker should see that there are no restrictions on the assignment of the policy.
4. **Margin:** Ordinarily the banker should advance only 85 to 90 per cent of the surrender value of the policy. But in the case of endowment policy, the banker may exceed this percentage if he is sure that premium of the policy is paid regularly.
5. **Insurable Interest:** For the validity of life insurance policy, the insurable interest is necessary. This interest is contained in the following cases:
   (a) That of a husband in the life of his wife.
   (b) That of the wife in her husband's life.
   (c) That of a person in his/her own life.
6. **Legal Assignment:** Before advancing money, the legal assignment of the policy should be taken by the banker. For example, if the policy is taken out by a husband for the benefit of his wife, the husband and wife should sign the assignment. According to Section 38 (1) of the Insurance Act, 1938, "the assignment can be made either by an endorsement on the policy itself or by a separate instrument signed in either case by the transferor or his duly authorised agent and attested by at least one witness specifically setting forth the fact of the transfer or assignment."
7. **Precautions Regarding Certain Policies:** Some insured policies cannot be legally assigned, e.g., the policy which comes under Section 6 of the Married Women's Property Act which creates a number of profits for the wife and children of the insured. The banker should not grant any advance against such policy.

8. **No Prior Encumbrances:** While granting loans, the banker should make it clear from the Corporation that the policy does not have any prior encumbrances or charge against it.

   In short, before accepting life insurance policy as security the banker should satisfy himself that the insured person has completed all the formalities and the premium also is paid regularly. Thus, the banker may avoid his risks or at least minimise his risks.

F. Advance Against Fixed Deposits Receipts

The term 'Fixed Deposit' means the money or deposit which is repayable on the expiry of a fixed period of time. This time-period may vary from 15 days to 60 months. In case a person deposits his surplus funds or money with the bank for some fixed period, he (customer) is issued 'Fixed Deposit Receipt' by the bank. The Fixed Deposit Account cannot be withdrawn before the expiry date, as mentioned in the Fixed Deposit Receipt. But sometimes, depositor may require advance-money before the due date of maturity. In such case, ordinarily banks extend advancing facility to their customers, but it should be noted here that banks are not bound to extend such facility. Another option is beneficial for the banker and the customer. Suppose, a fixed deposit is made for 36 months and the customer demands money after one or two months, it will be better for the customer to take loan against his Fixed Deposit Receipt. In such case the banker will gain by charging a higher interest rate than allowed on deposits.

Precautions in Advancing Against Fixed Deposit Receipt

While granting loans and advances against Fixed Deposit Receipts, the banker should take the following precautions:

1. **Receipt must be Issued by Concerned Bank:** When the bank grants loans and advances against the Fixed Deposit Receipt, it should be issued by the bank itself. The bank should not grant loans and advances on the Fixed Deposit Receipt which has been issued by another bank. For instance, State Bank of India issued a Fixed Deposit Receipt to Mr. A and in case Mr. A requires money against such receipt, it will be good for State Bank of India to sanction loan against the receipt, as in such case, there will be no risk for the banker.
2. **Original Depositor:** While advancing money, the banker should see that loan must be granted to the person whose name has been entered in Deposit Receipt. In case the Fixed Deposit Receipt is in favour of two or more than two persons, the loan is sanctioned to one of them, the banker should obtain a letter of authority on which the signatures must be made by depositors.
3. **Maintain Ledger and Register:** Where the banker grants loans and advances against the Fixed Deposit Receipt, the banker should made a note of its lien across the receipt as well as in the Fixed Deposit Ledger and Register.
4. **Margin:** The loan must be granted by the banker with the margin of 5 to 10 per cent. The bank should not sanction loan exceeding the Fixed Deposit Receipt value. For instance, Mr. A has been issued a Fixed Deposit Receipt of Rs. 10,000 on January 11, 1993 and in case he demands loan on March 4, 1993, the banker should not sanction loan more than Rs. 9,500.

5. **Interest Rate:** In case the bank advances money against the Fixed Deposit Receipt, the banker should get 2 per cent higher interest rate than what is payable by the bank on the deposit, if the deposit is in the name of the borrower only. For example, in case the deposit carries interest at 12 per cent per annum, the bank must be charged interest on loan against such a deposit at 14 per cent per annum.
6. **Others:** (a) The banker should discourage the loans to a minor against the Fixed Deposit Receipt on account of legal complication. (b) The banker should take actual possession of the later signed by the depositor or depositors, in case the customer fails to pay the loan on due date.

G. Advance Against Book Debts

Sometimes banks may grant loans and advances to the customers against the security of book-debts. Whereas the bank is fully satisfied with the solvency of the customers, such types of advances may be granted. In terms of Economics, the book-debt means "the amount which the customer of the bank has to get from other persons."

Book-debts are also known as 'actionable claim' and according to Section 130 of the Transfer of Property Act, 1882, the actionable claim means, "a claim to any debt or any beneficial interest in movable property not in the possession of the claimant which the civil courts recognise, as affecting grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent."

When the bank grants loans and advances against the security of book-debts, it may have to bear many risks on account of any default by the borrower. In such case, it may act as a debt-collector, which he does not like to be placed. Here, it is no doubt to say that book-debts are one of the more risky securities because in case the customer does not repay the loan, the bank may have to serve notice to the customer and if he (customer) does not follow the notice, in such case, the bank will have to start legal proceedings against his customer.

Precautions in Advancing Against Book Debts

The banker should take the following precautions while lending money against the security of book-debts:

1. **Writing:** While lending loans and advances against the book-debts as security, the banker has to act as an assignee of the debts whereas the customer acts as an assigner. The banker should see that the assignment or the agreement between the banker and the customer must be shown in writing.
2. **Undertaking:** Whereas advancing is granted against the security of book-debts he (banker) should obtain an undertaking from his borrower to pass all payments received by him in respect of the assigned debts to the banker.
3. **Solvency and Honesty of the Borrower:** Before granting loans and advances against the security of book-debts, the banker should carefully examine the solvency, creditworthiness and honesty of the borrowers. The banker should also check the past experience and market reports of the borrower.

4. **Margin:** While making advances against the security of book-debts, the banker should keep adequate margins. The basis of the margin must be modified from time to time, and generally it varies from 25 per cent to 40 per cent.
5. **Verify the Statement:** There should be legal responsibility for the banker to examine the periodical statement of the borrower and also examine the genuineness of the outstandings while lending money against the book-debts.
6. **Registration is Must:** While advancing against the security of book-debts to limited companies (on the basis of certain conditions), the bank's charges should be duly registered with the Registrar of Companies.
7. **Notice of Assignment is Necessary:** While lending money against book-debts, the banker should give the notice of assignment to the debtor. It is necessary to prevent the debtor from making payment of the debt to the customer.

Conclusion

From the above discussion, it is clear that the banker should take precautions very carefully while advancing money against the security of goods, documents of title to goods, Life Insurance Policy, real estate, Fixed Deposit Receipt and book-debts. If he fails to take precautions, he will have to bear a great loss.

Questions for Discussion

1. Explain the characteristics of a good security for advancing loan by a banker.
2. What are the principles of secured advances?
3. Mention the precautions which a bank should take in lending against goods and documents of title to goods as collateral.
4. Do you consider a Life Insurance Policy as a good security for an advance and if so, for what reason? In granting an advance against such a policy what are the factors you would specially examine and precautions you would take?
5. What precautions should a banker take while granting a loan against a Fixed Deposit Receipt and Book Debt?
6. Why do commercial banks avoid accepting real estate as security for their advances? What precautions should these take in such transactions?

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MODES OF CREATING CHARGE

INTRODUCTION

Lending is an important function of a commercial bank. While lending, a bank has to keep three important principles in mind, viz., liquidity, profitability and safety. In order to make a safe investment in loans and advances, banks usually insist upon security of some tangible assets. The various types of tangible assets on the security of which banks lend have already been discussed. But a security of tangible asset is of no use unless it is properly charged in favour of the bank. A bank can recover the loan in case of default by the borrower by disposing of the securities only if they are properly charged in favour of the bank. The charge must be registered with the appropriate authorities, wherever required, otherwise the bank may jeopardise its priority therein.

Modes of Creating Charge

The various modes of creating a charge are as follows:

A. Lien,
B. Pledge,
C. Mortgage, and
D. Hypothecation.

Each of these types of charges has different legal implications. Rights and obligations of the parties under each of these modes of creating charges are discussed below.

A. Lien

Lien is the right of a creditor to hold possession of the goods of the debtor till he discharges his debt. Right of lien entitles the creditor to retain the security or goods belonging to the debtor till the payment of debt. Lien can be either (a) a general lien, or (b) a particular lien. General lien entitles the creditor in possession to retain the goods till all his claims against the owner of the goods have been met. This is applicable in respect of all amount due from

the debtor to the creditor. But a particular lien is a specific lien which confers a right to retain those goods for which the amount is to be paid. These types of lien have been discussed in detail in the chapter entitled 'Banker and Customer Relationship.'

Section 171 of the Indian Contract Act confers the right of general lien on the bankers. The bankers have lien not only on the securities like cheques and bills of exchange, but also on goods coming into their possession unless there is a contract to the contrary.

B. Pledge

Pledge is the bailment of movable property to secure the payment of debt or the performance of a promise. Section 172 of the Indian Contract Act, 1872 defines pledge as the bailment of goods as security for the payment of a debt or performance of a promise. The person who offers the security is called the pledger or pawner and the creditor or the person who accepts the security is called the pledgee or pawnee.

Pledge is a special kind of bailment. The term 'bailment' has been defined by Section 148 of the Indian Contract Act as 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 off according to the directions of the person delivering them. The person who delivers the goods is called the 'bailor' and the person to whom the goods are delivered is called the 'bailee'. Bailment may be made for any purpose like repair, storing, security, etc. But pledge is made only for a specific purpose, i.e., as security for payment of a debt or performance of a promise. Thus, pledge is a kind of bailment having the following essential elements:

(a) Goods must be delivered by the pledger to the pledgee. The delivery to the pledgee may be actual or constructive. Delivery of the key of the warehouse where the pledged goods are stored is a constructive delivery and is sufficient to create a pledge. A pledge involves a transfer of possession of the goods pledged and not of title. The ownership of the goods pledged remains with the pledger.

(b) Pledge can be made only of movable properties. Money cannot be pledged.

(c) A contract of pledge must be supported by a valid consideration. The goods should be offered as security for the payment of a debt or the performance of promise.

Difference between Pledge and Lien

Following are the points of difference between a pledge and a lien:

1. Pledge is always created by a contract, whereas no contract is necessary for a right of lien. In most of the cases, lien is created by law.
2. Though in both the cases the possession of the goods is transferred to the creditor, yet in case of a lien, the party in possession of the goods does not have in general any right to sell the goods. In case of pledge, the creditor or the pledgee has right to sell the goods in his possession on the default by the debtor.

3. Right of lien is lost with the loss of the possession of the goods. But pledge is not necessarily terminated by return of goods to the owner. The goods pledged may be redelivered to the pledger for a limited purpose.
4. Lien is purely a passive right. Lien-holder can only hold the goods till the payment is made. Lien holder cannot enforce its claim through a court of law. But a pledgee enjoys the right to sue, right of sale and the right of lien.

Who can Pledge the Goods?

Generally pledge can be made by a person who is the real owner of the goods. But in the following cases, the non-owners of the goods can also make a valid pledge.

1. **Pledge by a Mercantile Agent:** Pledge by a mercantile agent, which is not authorised by the owner of the goods, will be valid if the following conditions are fulfilled:
   (a) The mercantile agent is in possession of the goods or documents of title to goods with the consent of the owner,
   (b) The mercantile agent acts in the ordinary course of business while making the pledge, and
   (c) The pledgee has no notice of the fact that pledger has no authority to pledge and he acts in good faith.
2. **Pledge by a Person in Possession Under Voidable Contract:** When the pledger has obtained possession of the goods pledged by him under a contract voidable as per Section 19 or 19 A of the Indian Contract Act, but the contract, has not been rescinded at the time of pledge, the pledgee acquires a good title to the goods provided he acts in good faith and without notice of pledger's defect of title. Where goods are obtained by theft, a pledge by a thief will not be valid and the pledgee in this case will acquire no lien over the goods.
3. **Pledge where the Pledger has only a Limited Interest:** Where a pawner or pledger has only a limited interest in the movable goods, the pledge can be valid only to the extent of that interest. Thus, where a person has only a mortgagee's interest or a mere lien, and he pledges the goods, the pledge will be valid only to the extent of that interest.
4. **Pledge by a Co-owner in Possession:** When there are several co-owners of the goods and the goods are in the sole possession of one of the co-owner with the consent of other co-owners, such a co-owner can make valid pledge of the goods.
5. **Pledge by Seller or Buyer in Possession after Sale:** A seller who has got possession of the goods even after sale can make a valid pledge provided the pawnee or the pledgee acts in good faith. Similarly, if the buyer obtains possession of goods with the consent of the seller before payment of price and pledges them, the pledgee will get a good title provided he does not have the notice of seller's right of lien or any other right.

Right and Obligations of Pledger

Section 177 of the Indian Contract Act, 1872 states as under:

"If a time is stipulated for the payment of the debt, or performance of the promise for which the pledge is made and the pawner makes default in payment of the debt or performance of the promise at the stipulated time, he may redeem the goods pledged at any subsequent time, before the actual sale of them; but he must, in that case, pay, in addition, any expenses which have arisen from his default."

Rights

From the above statement, the main rights of the pledger are given below:

(a) The pledger has a right to claim accruals to the goods pledged.
(b) The pledger has a right to receive any surplus from the pledgee in case of sale, that may remain with him after the debt is paid off.
(c) The pledger has a right to claim back the security pledged on repayment of the debt along with interest.
(d) In case the pledgee intends to sell the goods, the pledger has a right to receive a notice in stipulated time.
(e) In case there is any increase in the goods, the pledger has right to such increase.

Obligations (Duties)

(a) It is necessary for a pledger to disclose any fault or risk before the pledgee.
(b) The pledger must repay from the loan and take the delivery of the property from the pledgee within the stipulated time.
(c) The pledger is bound for any loss of the pledgee in case of any defects in pledger's title to the goods.

Right and Obligations of Pledgee or Pawnee

The rights of a pledgee are the following:

1. **Right of Retainer:** The first and foremost right of the pledgee is to retain the goods till he is paid not only the debt but also interest thereon, all necessary expenses incurred by him in respect of the possession or the preservation of the goods pledged.
2. **Right to Extraordinary Expenses:** Section 175 of the Indian Contract Act, 1872 states: "The pledgee has right to recover from the pledger extraordinary expenses incurred by him for the preservation of the goods pledged, but it should be noted here that pledgee has no right of lien for extraordinary expenses."
3. **Right in Case of Default of the Pledger or Pawner:** In case of default by the pledger in the payment of debt or the performance of promise at the stipulated time, the pledgee can exercise the following rights under Section 176 of the Indian Contract Act, 1872.

(a) The pledgee has a right to bring a suit on the debt and can retain the goods pledged as a collateral security.

(b) The pledgee has a right to sell the goods pledged after giving reasonable notice of sale to the pledger.

4. **Right of Particular Lien:** Under Section 174 of the Indian Contract Act, 1872, "A pledgee has no right to retain the goods for any debt or promise other than the debt for which the pledge was made." In the absence of anything to the contrary, the pledgee may retain the goods pledged for the subsequent advances made by him.

Obligation and Duties of Pledgee

(a) The pledgee is bound to return the goods pledged on the payment of debt. In case he fails to do so, he will be liable to the pledger for any loss.

(b) The pledgee is bound to take care of the goods properly and also keep the goods in proper place. In case he does not do so, he will be responsible for any destruction.

From the above discussion, it has been mentioned that the primary purpose of a pledge, is to put the goods pledged in the power of the pledgee to reimburse himself for the money advanced, when on becoming due, it remains unpaid by selling the goods after serving the pledger with a due notice. It is to be said that the pledgee becomes the owner of the goods pledged as such.

C. Mortgage

Mortgage is a mode of charge created on immovable properties, like land and buildings. It is the transfer of legal or equitable interest in property as security for the debt. Section 58 of the Transfer of Property Act, 1882, defines mortgage as "the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability." Mortgage, therefore, is a charge granted by a borrower to a lender on part or whole of his property for the repayment of a debt. The transferor is called "mortgager." The transferee is called "mortgagee." The instrument or deed by which the transfer is made is called the "mortgage deed."

Essential Features of a Mortgage

The following are the essential features of a mortgage:

(a) **Immovable Property:** A mortgage can be effected only in respect of immovable properties. Immovable properties include land and building, trees in the forest, standing crops, and any machinery that is permanently fixed to the earth.

(b) **Transfer of Interest in the Property:** Creation of a mortgage requires the transfer of interest in a specific immovable property. Transfer of interest does not mean transfer of ownership. The mortgager transfers some of his rights on the property to the mortgagee. Therefore, a mortgaged property cannot be sold without the consent of the mortgager in the event of any default.

(c) **Specific Property:** The interest to be transferred is always with respect to a "specific property." In other words, the property must be made specific through proper identity like its size, location, boundaries etc.

(d) **Possession with the Mortgager:** The actual possession of the mortgaged property is with the mortgager. He need not always transfer it to the mortgagee.

(e) **Object or Purpose of Mortgage:** The object of creating a mortgage is either to secure a loan or to perform an engagement. If the transfer of property is made for any other purpose, it cannot be called a mortgage.

(f) **Reconveyance of Interest:** On repayment of the loan the interest in specific immovable property is reconveyed to the mortgager. Thus, the mortgager gets back all his interest and rights in the property mortgaged as soon as he repays the loan.

(g) **Right of Sale:** In the event of non-payment of the loan, the mortgage has a right to sell the mortgaged property through the intervention of the court. But in case of legal mortgage, the mortgagee can sell the property without the intervention of the court.

(h) **Mortgage Deed:** An agreement in writing between the mortgager and the mortgagee is essential for creating a mortgage. The document which contains this agreement is called "mortgage deed."

Types of Mortgages

Mortgages are governed by the provisions of the "Transfer of Property Act." The Act recognises the following types of mortgages:

A. Simple mortgage
B. Mortgage by conditional sale
C. Usufructuary mortgage
D. English mortgage
E. Mortgage by deposit of title deeds.
F. Anomalous mortgage.

A. Simple Mortgage

In case of simple mortgage, the mortgager binds himself personally to pay the mortgage money. The mortgager does not transfer the possession of the property. If he fails to pay according to his contract, the mortgagee cannot directly sell the property. The sale must be through the intervention of the court. In other words, the mortgagee can sell the property through the intervention of the court. As the possession over the property remains with the mortgager, this mortgage is called "non-possessory." A simple mortgage is preferred by banks to other types of mortgages.

B. Mortgage by Conditional Sale

This type of mortgage is created subject to certain conditions. The mortgager ostensibly sells the mortgaged property with any one of the following conditions:

(a) That the sale shall become absolute if the mortgager fails to pay the mortgage money on a certain date.

(b) That the sale shall become void if the mortgager pays the mortgage money.

(c) That the mortgagee shall re-transfer the property to the mortgager if the mortgager makes payment of mortgage money on a certain date.

The following are the essential features of such a mortgage:

(i) It is an ostensible sale and not a real sale.

(ii) The possession of the property continues with the mortgager.

(iii) The mortgager does not have any personal liability.

(iv) In the event of non-payment, the mortgagee has a right to sue for foreclosure only and not for the sale of property.

Foreclosure means that the mortgager loses his right to redeem the mortgaged property in case of non-payment of the mortgage money. The mortgagee will get this right of foreclosure through the court.

C. Usufructuary Mortgage

Under this type of mortgage:

(a) The mortgagee is authorised to retain the possession of property till the loan is repaid.

(b) The mortgagee is also authorised to receive the income, like rents and profits arising from that property. The income so received is to be appropriated towards the loan amount. So, the liability of the mortgager is gradually reduced under this type.

(c) In the event of non-payment, the mortgagee can sue neither for the mortgage money nor for the sale of property. Even the right of foreclosure is not available.

(d) The only remedy available is to retain the possession of property, and receive the income arising therefrom, till the loan is settled.

(e) If the mortgager fails to redeem the property within 60 years, the mortgagee become the absolute owner.

D. English Mortgage

Under this type of mortgage:

(a) The mortgager transfers the property absolutely in favour of the mortgagee.

(b) This transfer is subject to a condition that the property will be transferred to the mortgager on repayment of the mortgage money.

(c) In addition to this absolute transfer, the mortgager binds himself personally liable to repay the mortgage money.

E. Mortgage by Deposit of Title Deeds

This type of mortgage is also called "equitable mortgage." Under this type of mortgage:

(a) There is a mere deposit of little deeds to property.

(b) The intention of the deposit is to secure a loan.

This mortgage does not require registration. It is most popular with banks.

F. Anomalous Mortgage

A mortgage other than any of the above five mortgages is an anomalous mortgage. It takes various forms depending upon custom, local usage or contract. In real practice, it takes the form of any two mortgages stated above.

Legal and Equitable Mortgage

Legal mortgage may be defined as "the creation by deed of a legal estate or interest inland as a security for the payment of money due, or to become due in favour of the person who takes the security, subject to the mortgager's right to have the estate so created extinguished on repayment of the loan with interest." Thus, in the case of a legal mortgage, the transfer of the legal rights to the person to whom the security is given, is essential.

An equitable mortgage may be created by an agreement, expenses or implied, that an equitable interest in the property, may pass to the mortgagee as security for a debt due. In such case, the mortgager deposits the title deeds with the mortgagee with the intention of giving the mortgagee an equitable interest on the property. In India, equitable mortgages are allowed in Mumbai, Kolkata, Chennai and Delhi.

Merits of Equitable Mortgage over the Legal Mortgage

An equitable mortgage has the following merits over the legal mortgage:

1. **Registration Deed:** In case of equitable mortgage, no registered deed is needed as an evidence to the transaction while in the case of legal mortgage it is a must. It is made clear that the borrower may have time and money under equitable mortgage.
2. **Creation without Publicity:** It is not essential for equitable mortgage to be registered. Generally, it may be created without any publicity and this may not affect the statutes of the borrowers.
3. **Less Time Consumed:** In case of an equitable mortgage, the time is less required as compared to a legal mortgage. Under equitable mortgage, if a customer wants an advance against his immovable property and can satisfy the bank authorities, the money may be granted to him without any delay.
4. **No Need for New Deed:** In case of an equitable mortgage the title deed may be returned to the mortgager who can redeposit for raising the new loan. While in the case of legal mortgage, a new deed and registration is always needed.

Demerits of Equitable Mortgage over the Legal Mortgage

Equitable mortgage has a number of demerits due to which legal mortgage is preferred by the banks. The demerits of the equitable mortgage over the legal mortgage have been discussed below:

1. Equitable mortgage is a time-consuming as well as expensive process because property mortgaged can be realised only through the court's order.

2. Equitable title may be affected by the legal mortgage.
3. The borrower may subsequently execute a legal mortgage in favour of another party.
4. An equitable mortgage is full of risk, fraud and negligent dealing. Section 78 of the Transfer of Property Act, 1882 lays down as "Whereas through fraud, misrepresentation or gross neglect of a prior mortgagee, another person has been induced to advance money on the security of the already mortgaged property, the prior mortgagee shall be postponed to the subsequent mortgagee."

   From the above discussion, it may be said that although certain demerits are associated with equitable mortgages, the merits far outweigh them. The risks may be avoided if necessary precautions are taken by the banker.

Rights of Mortgager

A mortgager has the following rights:

1. **Right to Redeem Mortgaged Property:** It is the most important right of the mortgager. After making payment of the debt the mortgager can redeem his property.
2. **Right to Inspect and Copy Documents:** A mortgager has a right to inspect and copy documents if he has deposited title deeds with the mortgagee.
3. **Right to Improvement and Accretion:** In case any improvement or accretion in the mortgaged property happens, the mortgager has a right to receive or enjoy that improvement.
4. **Right to Get Benefit of New Lease:** If the mortgagee has got the lease of the mortgaged property renewed, the mortgager has a right to get the benefit of such renewal.
5. **Right to Possession:** After making payment of the mortgage debt, the mortgager has a right to take back the possession of the property and return of documents of title to the property duly released.

Rights of Mortgagee (Banker)

A mortgagee has the following rights:

1. **Right to Foreclosure:** In case the mortgager fails to pay the debt after it has become due, the mortgagee can file a suit for foreclosure. Foreclosure means that the mortgager loses his right to redeem the mortgaged property.
2. **Right of Sale:** The mortgagee also has a right to sell the property with or without the permission of the Court (in certain cases under Section 69) if the mortgager fails to pay the debt when it has become payable.
3. **Right to Sue for Payment:** A mortgagee also has a right in the alternative (of the above two rights) to file a suit for payment when the amount of the debt has become due.
4. **Right to Re-imbursement of Certain Expenses:** If the mortgagee has to spend some money on maintenance, insurance or payment of lease rent, he has a right of re-imbursement of such expenses from the mortgager. He is also entitled to 9% interest per annum thereon.

5. **Right to Possession and Income from Mortgaged Property:** In case the mortgager fails to pay, the mortgagee has a right to possession of the property till the debt is paid. He also has a right to appropriate any income received from such property.
6. **Right to Accretion:** A mortgagee has a right to hold as security any accretion to the mortgaged property which occurs after the date of the mortgage in the absence of any contract to the contrary.

D. Hypothecation

In layman's language mortgage of movable goods is called hypothecation. According to Hart, "it is a charge on a property of which neither ownership nor possession is transferred to the creditor." In simple words, it is a pledge without transferring the possession of goods. The salient feature of hypothecation is that neither the ownership nor possession is transferred. Instead a charge is created to give possession of the goods to the lender (banker) whenever he asks him to do so. The banker enjoys the right and powers of a pledgee. Gopal Singh Hira Singh Vs Punjab National Bank (1976) A.I.R. Delhi 115, "The borrower is in actual physical possession but the constructive possession is still of the bank because, according to the deed of hypothecation, the borrower holds the actual physical possession not in his own right as the owner of the goods but as the agent of the bank." The High Court held, in law there was no difference between pledge and hypothecation with regard to legal possession of the bank. However, to enforce the claim it is essential for the bank to take possession of the hypothecated property on its own or through the Court. In case the banker fails to do so he will be deemed to have waived his right as a hypothecatee. His debt will become unsecured.

Risks in giving Loans Against Hypothecation: Risks in hypothecation are greater as compared to those in pledge because the possession of the goods is with the borrower.

(a) **Greater Chances of Fraud:** The borrower may not give possession of the goods or may sell the entire stock. He may also hypothecate the same goods or may sell the entire stock. He may also hypothecate the same goods with another banker.

(b) **High Legal Costs:** To recover possession of hypothecated goods, a banker might have to take legal action against the borrower. It will be costly in terms of money and time.

(c) **No Liquidity:** It will take a longer time to recover the possession of goods and realise the debt.

Precautions to be Taken by a Banker in Case of Lending Against Hypothecation

A banker should take the following precautions:

(a) **Loans to be given to Reputed Parties Only:** A banker should sanction loan only to such customers who have good reputation and sound financial position. Such parties should have a clean record of past dealings.

(b) **Regular Inspection of Hypothecated Goods:** The bank should regularly inspect the stock of the hypothecated goods. It should also verify the stocks with account books.

(c) **Periodical Statement of Stocks:** The banker should ask the borrower to submit periodical statement of stock. It should verify those statements with the stocks of the goods.

(d) **Signboard of Hypothecation in Favour of the Banker:** The banker should ask the borrower to display a signboard on the gate of the godown where the goods are stored indicating that the goods are hypothecated with the banker. The banker should regularly check that such display is being done. It will be a public notice and would avoid the chances of duplicate charge being created on those goods.

(e) **Insurance:** The banker should ask the borrower to get the goods insured against fire, theft, flood etc., and assign the policy in its favour. The banker should inform the insurer that the goods are hypothecated with him.

(f) **Registration of Charge:** If the borrower is a company, the banker should get the charge registered under Section 125 of the Companies Act, 1956. The charge is to be registered with the Registrar of Companies within 30 days of its creation. The banker should obtain a copy of registration of the charge. The banker should also get declaration from the company that it will not create a second charge over those goods. This undertaking should also be registered with the Registrar of Companies along with the registration of charge.

(g) **Declaration from the Borrower that he is not Availing Similar Facilities from other Banks:** The banker should obtain a declaration from the borrower to this effect. This undertaking should also be obtained periodically along with periodical statement of stock of hypothecated goods. This declaration should be cross-checked with the information obtained from other banks of the area.

From the above discussion, it is made clear that the banker should give the facility of hypothecation to honest persons only because the goods remain in the possession of the borrower. In case the loan is granted to any unscrupulous person, he may sell the goods hypothecated and pay off other creditors.

Conclusion

To conclude, we have discussed various methods of creating a charge on the security offered for a bank-loan. Now we are in a position to say that every method has its own importance and a few methods are inter-related. The function and achievement of all methods will depend upon the circumstances and financial position of the bank as well as its customer.

Questions for Discussion

1. Discuss the various methods of creating a charge on the security offered for a bank-loan.
2. Define 'pledge'. What are its essential ingredients? Who can create a valid pledge? What are the rights and obligations of the pledger and the pledgee?
3. Define mortgage and explain the various types of mortgages.
4. What are legal and equitable mortgages? Explain their relative merits and demerits to the banker.
5. What do you know by hypothecation? What precautions should a bank take while advancing loans against hypothecation of goods?

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GUARANTEES

INTRODUCTION

Guarantee is an important method of securing banker's advances to the customer. It is the personal security of the third party which commands the confidence of the banker. In case the customer is unable to provide the security of tangible asset or the value of such security which is not sufficient to cover the loan amount, the banker may ask the customer to provide a 'guarantee' for the repayment of the amount. J.M. Holden observed, "When a guarantor signs a guarantee in favour of a banker, he is declaring: 'You may advance money to your customer, Mr. X and if he does not repay, I will be responsible.'"

Meaning

Whenever the borrower does not have sufficient security to offer or if he has exhausted all securities, he can request the banker to accept the surety of the third party. On several occasions the banker agreed to this. However, such offer should come from the borrower himself and not by the banker. The person who gives security for the loan raised by the principal debtor is called "GUARANTEE."

Definition

Section 126 of the Indian Contract Act, 1872 defines a contract of guarantee as "a contract to perform the promise or discharge the liability of a third person in case of his default."

According to the Indian law, guarantee may be either oral or written. But according to English law, a guarantee is defined as a "Promise made by one person to another to be collaterally answerable for the debt, default or miscarriage of a third person and must be evidenced in writing."

Three parties are involved in this contract of guarantee. They are as follows:

(a) **Applicant** : The principal debtor-person at whose request the guarantee is being executed.

(b) **The Beneficiary** : Person to whom the guarantee is being given and who can enforce in case of default.

(c) **The Guarantor** : The person who undertakes to (surety) discharge the obligations of the applicant against his default.

Thus the guarantee is a collateral contract, consequential to a main contract between the applicant and beneficiary.

Example

Suppose Chaluvaiah requests Chandrappa to lend Rs. 50,000/- to Yogananda and guarantees that Yogananda will repay the amount within a stated period, and that on Yogananda is failure to repay the amount he (Chaluvaiah) will himself pay to Chandrappa, it is a contract of guarantee. Hence chaluvaiah is the guarantor, Yogananda is the principal debtor and Chandrappa is the creditor.

Necessity for Bank Guarantee

Applicant Dasarath and beneficiary Yogananda have a business contract. This is the primary or main contract. Yogananda wants to cover the risk of any possible non-performance of the contract by Dasarath. So Yogananda can ask for a monetary deposit as a cover. Dasarath is not willing to block his money (which he can otherwise profitably use). So Dasarath approaches his bank with a request to issue a Bank Guarantee in favour of Yogananda. Thus here has arisen the need for a Bank Guarantee.

Essentials of a Valid Guarantee

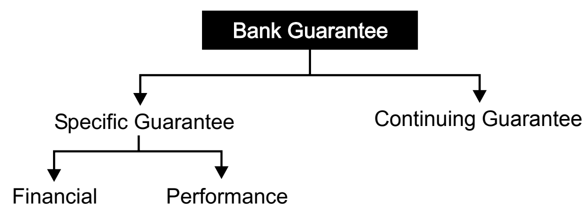
A valid contract of guarantee must satisfy certain essential requirements stated in the definition.

1. **Valid Contract:** The contract of guarantee should have all the essential elements of a valid contract. viz consideration, free consent, competence of the parties, legality of object and consideration.
2. **Guarantee cannot be Obtained by Coercion**: If there is coercion, there will not be valid contract as consent is not free.
3. **Consideration:** There need not be a direct consideration between the creditor and guarantee. The money or any other consideration received by the principal debtor is sufficient for the contract of guarantee. Thus there should be some consideration and if consideration is totally absent then the contract of guarantee will be invalid.

4. **Competence:** The contract of guarantee must be made by the parties who have competence to contract. The creditor and surety must be competent to enter into valid contract. Principal debtor can be a minor. Here surety is regarded as principal debtor and is personally liable to pay the debt.
5. **Primary Liability:** There must be some one primary liable as principal debtor other than surety. The contract of guarantee pre-supposes the existence of liability enforceable by law.
6. **Conditional:** In a valid contract of guarantee there must be a conditional promise to be liable on the default of the principal debtor. Thus, the liability of surety arises only when the principal debtor makes a default.
7. **No Misrepresentation:** While obtaining surety the facts should be revealed to him. The guarantee should not be obtained by misrepresenting the facts to the surety. However, as it is not a contract of absolute good faith, it does not require complete disclosure of material facts to the surety either by principal debtor or by the creditor. But the facts, which are likely to affect the degree of surety's responsibility must be truly revealed to him. Otherwise it is not a valid contract of guarantee.
8. **No Concealment of Facts:** The surety should be informed of the facts which are likely to affect the liability. If such facts are conceded the guarantee becomes invalid.
9. **The Contract of Guarantee Must be Oral or in Writing:** But as per English law it must be in writing.

Kinds of Guarantees

Under Section 126 of the Indian Contract Act, 1872, a contract of guarantee may be either oral or in writing though a banker shall put it in writing to avoid any dispute. But in oral contract, the existence of the contract is very difficult to prove.



1. **Specific or Ordinary Guarantee:** Specific or Ordinary Guarantee means a guarantee for the transaction between the debtor and the creditor. Where the advancing money is made against the security of Specific Guarantee, the money should be lent by the banker on a separate loan account. In such case, the liability of the surety extends only to a single transaction.

Illustration

Suppose S stands surety for the repayment of loan of Rs. 20,000/- given by a Bank X to Y. This is a Specific Guarantee. The liability of S will come to an end as soon as Y repays the

loan to the Bank X. In case where the Bank X advances another loan to Y, subsequently, S will not be liable.

The specific guarantee may be either Financial or Performance:

(a) **Financial Guarantee:** It means, "to guarantee the customer's (applicant's) financial worth, creditworthiness and his capacity to take up financial risks."

(b) **Performance Guarantee:** It means, "to guarantee the obligations relating to the technical, managerial, administrative experience and capacity of the customer (applicant)."

However, the liabilities under both these types of bank guarantee are reduced to monetary terms. Bank is not going to be asked to perform the contract in case of default by the applicant of a performance guarantee; because what is guaranteed is not the performance but only the financial loss arising out of the non-performance of the commitment made by the applicant. Such performance guarantee is issued only on behalf of first-class parties.

2. **Continuing Guarantee:** According to Section 129 of the Indian Contract Act, 1872, "a continuing guarantee is that which extends to a series of transactions." It may be remembered here that this guarantee is not confined to single transaction. Under this, the amount of the fluctuating balance on a cash-credit or an overdraft account may be covered by the continuing guarantee. But it should be noted here that 'the payment by installments within a stated time is not known as continuing guarantee'.

Illustration

If X considers that State Bank of Mysore employs Y in collecting deposits promises State Bank of Mysore to be responsible to the amount of Rs. 20,000/- for the due collection and payment by X of those deposits. This is a continuing guarantee.

Revocation of Continuing Guarantee

A continuing guarantee is revoked by the following ways:

(a) **By Notice:** Section 130 of the Indian Contract Act, 1872, states: "A continuing guarantee may be revoked any time after giving a notice to the creditor in respect of future transactions. In such a case, the surety would not be responsible for future transactions which may take place between the creditor and the principal debtor after he has revoked the contract of guarantee."

(b) **By Death:** According to Section 131 of the Indian Contract Act, 1872, "the death of the surety operates as a revocation of the continuing guarantee with regard to the future transactions unless the contract provides otherwise. No notice of death need be given to the creditor."

Purpose of the Guarantee: The purpose of the above guarantees is discussed below:

	Financial	Performance	Deferred Payment Guarantee
(a)	In lieu of earnest money/tender deposit retention money.	For performance of machinery/goods supplied.	Bank guarantees payment of specified amount over a period of one year but less than 10 years.
(b)	Issued to Government departments for releasing disputed claims money like Excise/Customs Duty etc.	For satisfactory performance of Turnkey Projects for a specified period.	

From the above discussion, it is clear that the banker always prefers to have a continuing guarantee, so that the guarantor's liability may not be limited to the original advance but should also extend to all subsequent debts. Section 38 of the Indian Partnership Act, 1932 lays down that "a continuing guarantee given to a firm or a third party in respect of the transactions of a firm, is, in the absence of agreement to the contrary, revoked as to future transactions from the date of any change in the constitution of the firm."

Contract of Guarantee

The contract of guarantee is distinctly different from the contract of indemnity. In terms of Section 126 of the Indian Contract Act, 1872, "a contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default." The same Section further states that "a guarantee may be either oral or written." The above statements of the Act may be made clear by the following example.

If Mr. Eshwarappa applying for a loan of Rs. 12,000/- induces his friend, Mr. Gopikrishnan to promise to Mr. Sreeram to repay the loan in case of Mr. Eshwarappa default, such contract is called a contract of guarantee.

If we analyse the above example, the following points will be seen:

There are three parties in a guarantee and three sub-contracts emerge, i.e.,

(a) the contract between principal debtor and the creditor.
(b) the contract between principal debtor and surety.
(c) the contract between surety and creditor.

Here, Mr. Eshwarappa is the principal debtor, Mr. Gopikrishnan is the surety and Mr. Sreeram is the creditor.

Purpose of the Contract

The purpose of the contract of guarantee may be discussed below:

(a) To secure the honesty and fidelity of someone who is to be appointed to some office.
(b) To secure someone from injury arising out of a wrong committed by another.
(c) To secure the performance of something which may be related to a mercantile engagement.

Contract of Indemnity

Section 124 of the Indian Contract Act, 1872, defines indemnity as "a contract by which one party promises to save the other from loss caused to him by the conduct of the promiser himself, or by the conduct of any other person."

According to English law, "a contract of indemnity is a promise to save another harmless person from loss caused as a result of a transaction entered into at the instance of the promiser." The scope of the English definition is incomplete because it does not make a distinction between loss caused by the conduct of the promisee, and by the conduct of any other person.

Parties to Indemnity

(a) **Indemnifier:** Person who promises to make good the loss.
(b) **Indemnified:** Person whose loss is to be made good.

Example

If Mr. Swaroop claims to have lost a bank draft for Rs. 3,000 issued by Canara Bank in favour of Mr. Dheraj and agrees to indemnify the bank against consequence of any proceedings which Mr. Dheraj may take against Canara Bank.

Here Swaroop is the Indemnifier and Canara Bank is the Indemnified.

Analysis of the Definition

If we analyse the above definition given by Section 124 of the Indian Contract Act, 1872, the following points may be included in a contract of indemnity:

(a) The cases where loss is caused by the conduct of the promiser himself or by the conduct of any other person.
(b) The express promise of the indemnifier may be included.

It should be noted here that Indian courts agree with the English definition of contracts of indemnity. In the case of Gajans Moheshwar Vs Moheshwar Madan (1942) Bombay 302, Justice observed that ..."......Section 124 and 125 of the Contract Act are not exhaustive of the law of indemnity, and that the courts here would apply the same principles that the courts in England do."

Difference between Contract of Guarantee and a Contract of Indemnity

The difference between a contract of guarantee and a contract of indemnity is as follows:

1. **Number of Contracts:** In a contract of indemnity there are only two parties, viz., the indemnifier and the insured or the promisee or the party indemnified. Whereas in a contract of guarantee, there are three parties, i.e., the creditor, principal debtor, and surety.
2. **Nature of Liability:** In contract of guarantee, the liability is secondary, the primary liability being that of the principal debtor whereas in the contract of indemnity, the liability of a promiser is primary and independent.
3. **Parties' Interest:** The person giving the guarantee has no other interest in the transaction apart from his guarantee. But a person giving an indemnity may have some other interest in the contract.
4. **Purpose of Contracts:** A contract of indemnity is made for the reimbursement of loss but a contract of guarantee may be to provide necessary security to creditor against his advances.
5. **Rights of Parties:** In a contract of indemnity, the indemnifier can bring the suit against the third party in the name of the indemnified whereas in a contract of guarantee, the surety becomes entitled in law to proceed against the principal debtor in his own right after he has discharged the debt payable by the principal debtor to the creditor.

Rights of the Surety

Right of the surety may be classified into the following three heads:

1. Right against the principal debtor.
2. Right against the creditor.
3. Right against the co-sureties.

1. **Right Against the Principal Debtor:** The surety may exercise the following rights against the principal debtor:
   (a) **Subrogation:** According to Section 140 of the Indian Contract Act, 1872, "When a surety has paid the guaranteed debt on its becoming due or has performed the guaranteed duty, on the default of the principal debtor, he is invested with all the rights which the creditor had against the debtor."
   (b) **Indemnity:** Section 145 of the Indian Contract Act, 1872 lays down that the surety has the right to recover from the principal creditor whatever sum he has rightfully paid under the guarantee.
2. **Right Against the Creditor:** By Section 141 of the Indian Contract Act, 1872, a surety is entitled to get the benefit of every security which the creditor has against the debtor at the time when the contract of suretyship is entered into, whether the surety knows of the existence of such security or not.

3. **Right Against the Co-sureties:** The 'co-sureties' means 'when a debt has been granted by more than one person'. Section 146 of the Indian Contract Act, 1872, gives a right of contribution among them. *This can be made clear by the following illustration.*

   Narendra, Nagaraj and Kumar sureties to Central Bank of India for the sum of Rs. 9,000/- lent to Mahalingaiah. If Mahalingaiah makes default in payment, Narendra, Nagaraj and Kumar are liable, among themselves, to pay Rs. 3,000/- each.

Liability of the Surety

The liability of the surety is called as secondary, as his liability arises only on default by the principal debtor. Section 128 of the Indian Contract Act, 1872 lays down that "Whereas the parties do not agree to the extent of the liability or the surety does not put up any limit of his liability at the time of entering into the contract, the liability of the surety will be co-extensive with that of the principal debtor."

Example

If Mr. Narayan guarantees to Mr. Venkatesh the payment of the Bill of Exchange by Mr. Muniyappa, the acceptor. In case the bill is dishonoured by Mr. Muniyappa, in such case Mr. Narayan is liable not only for the amount of the bill but also for any charges which may become due on him.

Rights of the Banker

Under a contract of guarantee, the rights of the creditor, who may be a banker, are the liabilities of the surety. The banker has a right of general lien on the securities of the surety in his possession. This right may arise when the principal debtor has made default and not before that. If the surety is declared insolvent, the banker is entitled to sue the principal debtor for the recovery of the money.

Liabilities of the Banker (Obligation)

According to Indian Contract Act, 1872, the following are the liabilities on a banker in a contract of guarantee:

1. **Not to Discharge the Principal Debtor:** Section 134 of the Indian Contract Act states, "The surety is discharged by a contract between the creditor and the principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor."
2. **Not to Give Time to the Principal Debtor:** Section 135 of the said Act lays down that "A contract between the creditor and the principal debtor, by which the creditor makes a composition with the promise to give time to, or not to sue the principal debtor, discharge the surety assents to such contract."
3. **Not to Conceal Material Facts:** Section 140 of the Indian Contract Act provides guarantee which the creditor obtains by means of keeping silence as to material circumstances is not valid.

Example

Swaroop guarantees to Sreenidhi payment for coal to be supplied by him to Preran of the amount of 100 tonnes. Sreenidhi and Preran have agreed that Preran should pay Rs. 20/- per ton beyond the market price, such excess to be applied to liquidation of an old debt. In such example, hereby Swaroop is not liable as surety.

In short, besides the above, the banker should ensure that the guarantee is not obtained by misrepresentation. Any guarantee which has been obtained by means of misrepresentation made by the creditor, concerning a material part of the transaction is invalid.

Merits and Demerits of Guarantee

A contract of guarantee is a direct contract between the creditor and the surety, yet it is necessary that it must be entered into with the knowledge and consent of the principal debtor. In addition, before accepting a guarantee as a security, the banker should see the merits and demerits of the contract of guarantee. Hence, the banker should also take precautions while making advances against guarantee as a security. We shall therefore discuss all the points further as follows.

Merits of Guarantee

In practice, the following are the merits of guarantee:

1. **Betterment:** Where the bank grants loans and advances on the security of guarantee, it (contract of guarantee) may be in a better position than making an unsecured advance. But it should be the legal duty of the banker to see the financial and credit position of the surety in market. In case the debtor fails to repay and if the surety is in sound position, the banker can recover the amount from the surety.
2. **Easy:** If a person wants to enter into contract of guarantee, there may be no legal and technical formalities before him. In other words, he may enter into contract of guarantee without any difficulty. Whereas the bank takes the guarantee in writing, the contract of guarantee will play a positive and sufficient role.
3. **No Need for Obligation:** Generally, whereas the bank grants loans and advances against several types of securities there may be a number of obligations on the part of the banker. But in contract of guarantee, there may be no need for any obligation on the part of the banker because it is not possible for the banker to take care of any tangible assets of the borrower.

Demerits of Guarantee

Following are the drawbacks or demerits of guarantee:

1. **Difficulty in Valuation:** It is very difficult for the banker to determine the real value of guarantor. In case the banker does not understand the real position of the guarantor and if loan is granted against his surety and the debtor fails to repay the amount, in such case the banker will not recover the amount from the guarantor.

2. **Difficulty in Insolvency:** The value of the security given by the guarantor depends upon his solvency. In case the guarantor is declared insolvent, the security will become worthless.
3. **Complicated Legal Formalities:** In a contract of guarantee the banker has a number of obligations which have to be followed very strictly because the provisions of guarantee are to be made in favour of the guarantor.
4. **Difficulty in Drafting:** The drafting of the contract of guarantee is very difficult and a number of technical words are to be used. If it is not properly drafted, the guarantor may avoid the liability in case of default by the principal debtor.

Precautions to be Taken by the Banker in a Contract of Guarantee

While granting advances against the security of guarantee, the banker should take the following precautions:

1. **Financial Soundness of the Guarantor:** Before making advances, the banker should enquire about the integrity, creditworthiness and capacity of the borrower as well as the guarantor or surety. If the proposed guarantor does not have these qualities and the loan is granted on his guarantee, in real practice, such amount is called an unsecured loan. Therefore, it is essential for a banker to accept the guarantee only if the guarantor's financial position is very strong or sound.
2. **Careful Drafting:** Before granting loans, the banker should see whether the contract of guarantee is drafted properly or not. It should not contain any loophole because in case the principal debtor fails to repay the amount, the bank may not be in a position to recover the amount from the guarantor. So, it is necessary for the bank to get the contract drafted by the legal experts of the bank.
3. **Contract must be in Writing:** Under Section 126 of the Indian Contract Act, 1872, a contract of guarantee may be either oral or written. But in actual practice or on the safe side, the banker should obtain guarantee from the guarantor in writing on the printed form. The banker should also contain the terms and conditions of the contract of guarantee in writing.
4. **Powers of the Guarantor:** Before making an advance, the banker should examine the powers of the guarantor who gives guarantee to the bank. In case a loan is to be guaranteed by a joint stock company, the banker should properly study company's Memorandum and Articles of Association. For this, the banker should obtain a copy of certificate from the Board's resolution authorising the company to stand surety.
5. **Continuing Guarantee:** Whereas the loan is granted on a guarantee, the banker should see that the guarantee is going on continually or not. In case the guarantee is given for a specific loan, in such condition, the banker should not sanction loan after the original loan is repaid by the principal debtor.
6. **Capacity of the Parties:** While advancing money, the banker should examine the capacity of the principal debtor and the guarantor. If the guarantor is a minor, the banker should not accept the guarantee of a minor because he (minor) is not fit to enter into a contract of guarantee.

7. **No Modification in Contract:** Before granting loan, the banker should satisfy himself about the credit worthiness of the party. He (banker) should not take any step about the modification without the consent of the guarantor. If the banker does so, the liability of the guarantor will come to an end.
8. **Termination of Guarantee:** In respect of future transactions taking place, the guarantor may terminate his guarantee due to his insolvency. When the banker receives a notice about the insolvency of his guarantor, he should immediately stop the guaranteed account because if the debtor fails to repay the amount, the banker cannot recover the amount from his guarantor. Under Section 34 (2) of the Provisional and Section 46 (3) of the Presidency Towns Insolvency Acts, the banker has the right to proceed against the estate of such guarantor even if the principal debtor has not defaulted.

The contract of guarantee may terminate under the following points:

(a) On receipt of notice to the creditor of the guarantor's insolvency.
(b) On receipt of notice of principal debtor.
(c) On death of the guarantor, under the Indian Contract Act, the notice of the death of the guarantor need not be given to the creditor whereas according to English law, such notice is necessary.
(d) Notice of demand by the creditor on the guarantor.
(e) Change in the constitution of the borrower.
(f) Notice of revocation by the guarantor to the creditor.

From the above one or more events, the contract of guarantee will terminate.

Conclusion

From the above discussion, it is clear that the person who gives security for the loan, raised by the principal debtor is called 'Guarantee'. Banker has to take proper precautions while granting loans and advances on guarantee. If the contract of guarantee is used properly, it may act as a good guide while if it is used wrongly it may act as a master. Therefore, in order to minimise risks and defaults, the banker should take precautions properly.

Questions for Discussion

1. What do you mean by guarantee? Discuss necessity and various kinds of guarantees which are offered to the banks.
2. Explain a contract of guarantee and a contract of indemnity. Distinguish between them. What are the rights and liabilities of the surety and the banker in a contract of guarantee?
3. What are the merits and demerits of granting advances against a guarantee? What precautions should a banker take while making advances on the guarantee on a surety?

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Letter of Credit

INTRODUCTION

Modern banks facilitate trade and commerce by rendering valuable services to the business community. Apart from providing appropriate mechanism for making payments arising out of trade transactions, the banks gear the machinery of commerce, specially in case of international commerce, by acting as a useful link between the buyer and the seller, who are often too far away from and too unfamiliar with each other. Opening or issuing letters of credit is one of the important services provided by the banks for these purposes. The foundation of the banking business is the confidence reposed in the banking institutions by the people in general and the mercantile community in particular. The standing, reputation and goodwill earned by a banking institution enables it to issue instruments, known as Letters of Credit, in favour of traders and banks to meet the needs of their customers. In fact, a letter of credit carries a promise or an undertaking by the issuing banker which is valued and honoured on a global basis.

In actual practice, a Letter of Credit means "a document issued by a banker authorising the banker to whom it is addressed to honour the bills of the person named therein to the extent of certain amount."

Definition

A Letter of Credit has been defined by the International Chamber of Commerce as "an arrangement, however, named or described whereby a bank (the issuing bank) acting at the request and in accordance with the instructions of a customer (the applicant of the credit), is to make payment or to the order of a third party (the beneficiary) or is to pay, accept or negotiate Bills of Exchange (Drafts) drawn by the beneficiary or authorise such payments to be made or such drafts to be paid, accepted or negotiated by another bank, against stipulated documents and compliance with stipulated terms and conditions."

From the above definition of Letter of Credit, it is clear that there are following parties to a Letter of Credit.

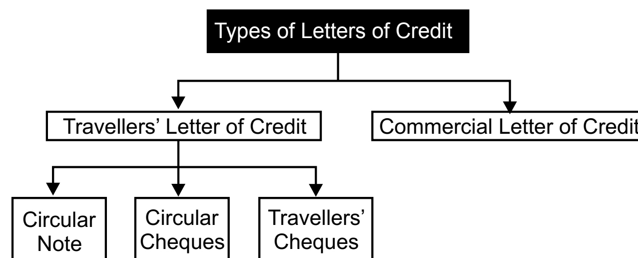
(1) The buyer.
(2) The beneficiary.
(3) The issuing bank.
(4) The notifying bank.
(5) The negotiating bank.
(6) The confirming bank.
(7) The paying bank.

1. **The Buyer:** The buyer who is the importer, applies to the bank for the opening of a Letter of Credit.
2. **The Beneficiary:** The seller, who is the exporter, is the beneficiary of the Letter of Credit.
3. **The Issuing Bank:** The bank which issues the Letter of Credit at the request of the buyer is the issuing bank.
4. **The Notifying Bank:** The notifying bank is the correspondent bank situated in the same place as that of the seller which advises the credit to the beneficiary.
5. **The Negotiating Bank:** It is the bank which negotiates the Bills or Drafts under the Letter of Credit.
6. **The Confirming Bank:** It is the bank the seller insists that the credit must be confirmed by it.
7. **The Paying Bank:** The paying bank is the bank on which the bill or draft is drawn. It can be the confirming bank, the issuing bank or the notifying bank.

Types of Letters of Credit

The Letter of Credit can be divided into two broad categories:

1. Travellers' Letter of Credit.
2. Commercial Letter of Credit.



These are discussed below:

I. Travellers' Letter of Credit

Such types of Letters of Credit are issued by the banks for the convenience of the travellers. The travellers are saved from the risk of travelling with heavy cash with them. The facility of such Letters of Credit can be available both for travelling in and outside the country. The characteristics of such Letters of Credit are as under:

(a) A Travellers' Letter of Credit is issued by a bank on its own branch/ branches or correspondent bank/banks situated anywhere in the world.

(b) It contains a request by the issuing bank to make payment up to the amount to the person named therein.

(c) The issuing banker may issue a Letter of Identification to the holder of the Letter of Credit. The signature of the holder must be attested therein.

Types of Travellers' Letter of Credit: The Travellers' Letter of Credit can be divided into the following forms:

1. **Travellers Cheque:** It is issued and drawn by a bank upon its own branch or another bank. It is a request by the issuing bank to the paying bank to pay a specified amount to the holder. It also contains the specimen signature of the holder for the purpose of identification.
2. **Circular Letter of Credit:** It is addressed to more than one banker. Details of the amount paid by the various bankers are entered in the proforma, printed on the back of the letter of credit. The holder is to deposit the required amount for which he wants a letter of credit with the issuing bank. The issuing bank charges its commission for the service.

   In case of a letter of credit, the banker issues an identification slip which bears the signature of the holder attested by the issuing banker. In a travellers cheque these signatures are on the travellers cheque itself.
3. **Circular Note:** It is like a travellers cheque. Unlike a letter of credit it is of specified denomination. In a letter of credit the banker has to make and entry at the time of the making payment. However, in a circular note, payment is made by the bank on surrender of the circular note.
4. **Circular Cheques:** These are like travellers cheques. However, these are not of specified denominations. The maximum amount payable is indicated on the circular cheque. No separate identification slip or letter is issued along with it. The holder's signature are on the circular cheques like those on the travellers cheques.
5. **Guarantee Letter of Credit:** In case of other letters of credit the holder has to pay in advance the required amount of the credit to the banker who issues letter of credit. In case of guarantee letter of credit, the holder is not required to deposit any amount in advance, he is only required to give guarantee of the amount required.

6. **Bank Draft or Demand Draft:** A bank draft or a demand draft is a bill of exchange drawn by one bank on its own branch or any other bank. The essential features of a bank draft are:
   (a) It is always drawn by a bank upon its own branch or another bank.
   (b) It is always payable on demand and it cannot be made payable to bearer.
   (c) Ordinarily, payment of a demand draft cannot be stopped or countermanded. It is because of this reason payment is demanded through a bank draft.

II. Commercial Letter of Credit

Such letters of credit are issued to facilitate trade and commerce particularly the international trade. An exporter is reluctant to send goods to the importer because he wants to minimise the risk for the payment. Similarly, the importer is also reluctant to send the payment in advance to the exporter. He is afraid that the exporter may not send the goods even after receiving payment in advance. The bank comes to the rescue (help) of both the parties. The documents of goods are sent through the bank with the instructions that the bank should deliver the documents viz., Bill of Lading or Freight Bill to the importer against payment or acceptance of the bill. The importer can get the delivery of the goods by surrendering the bill of lading to the shipping company and the exporter will get the payment from the bank.

However, in the above case a risk is involved. The importer may not pay or accept the bill. The exporter will have to spend unnecessary money in getting the goods back. Such risks can be avoided if a letter of credit is opened by the importer.

A letter of credit issued by the importer's bank guarantees the exporter that the bank will pay or accept the bill accompanying the documents sent through the bank.

The letter of credit specifies what goods have to be despatched and also the date by which the goods must be despatched. The exporter should strictly comply with the terms and conditions of the letter of credit. In case he fails to do so, the bank issuing the letter of credit will not liable to pay or accept the bill drawn by the exporter.

Types of Letters of Commercial Credit

1. **Documentary Letter of Credit:** When a clause is inserted in the letter of credit that the document of title to goods viz., bill of lading, insurance policy, invoice etc., must be attached to the bill of exchange drawn under the letter of credit. It is called a documentary letter of credit.
2. **Clean Letter of Credit:** If no such clause (as in documentary letter of credit) is inserted in the letter of credit, it is called a clean letter of credit. The documents of title in that case are sent directly to the importer. In a clean letter of credit there is greater risk for the banker. As such a banker issues clean letter of credit only to those customers, who have good reputation and credit in the market.

3. **Fixed Letter of Credit:** If the banker specifies in the letter of credit the amount of the bill to be drawn within the time fixed, it is called a fixed letter of credit. Such a letter remains valid until the specified amount is utilised within the specified time.
4. **Revolving Letter of Credit:** In case of revolving letter of credit, the banker specifies the total amount upto which the bills drawn may remain outstanding at a time. For example, X opens a letter of credit with City Bank for a total sum of Rs. one lakh valid for a period of 3 months. The beneficiary (exporter) can draw bills under the letter of credit with the condition that the value of such outstanding bills should not exceed Rs. one lakh at any given time.

   The main advantage of revolving credit is that the beneficiary may draw a bill for an amount higher, than the one specified in the letter of credit. Again there is no need of renewal again and again. However, it is complicated. It is difficult to ascertain how much amount is outstanding at a particular time.
5. **Revocable Letter of Credit:** Unless specified otherwise, a letter of credit will be deemed revocable (Art. 1 Uniform Custom and Practice).

   In case of revocable letter of credit, the issuing banker resumes the right to cancel or modify the credit at any time without notice. Therefore, such a letter of credit is hardly of any use. However, as per Article 2 of Uniform Custom and Practice, in the above case modification or cancellation will become effective only on receipt of the notice by the negotiating banker.
6. **Irrevocable Letter of Credit:** Such a letter cannot be modified or cancelled without the consent of the applicant and the beneficiary. As per Article 3 of Uniform Custom and Practice the issuing banker will be liable in case of irrevocable letter of credit if the exporter strictly complies with the terms and conditions of the letter of credit.
7. **Confirmed Letter of Credit:** When the banker issuing the letter of credit requests the advising bank in the exporter's country to signify his confirmation to an irrevocable credit and the advising bank accepts the request, it is called irrevocable and confirmed letter of credit. The advising banker is called confirming banker. He cannot cancel or modify his undertaking without the consent of the parties concerned.
8. **Unconfirmed Letter of Credit:** In case the issuing banker does not ask the advising banker to confirm the letter of credit, it remains unconfirmed letter of credit.
9. **With Recourse Letter of Credit:** You might recall that a bill of exchange may be drawn with recourse to the drawer. If such a bill is drawn under a letter of credit, it is called 'with recourse letter of credit'. In case of such a bill, if the drawee does not honour the bill, the banker as a holder can recover the payment of the bill from the drawer.
10. **Without Recourse Letter of Credit:** If an exporter wants to avoid his liability (as in the case of with recourse letter of credit) he can ask the importer to open a 'letter of credit without recourse to the drawer'. If the importer fails to honour the bill, the issuing banker cannot hold the drawer liable. He can hold only the drawee liable in such a case. The banker may realise the amount by selling the goods if the documents of title have not been given to the importer.

11. **Transferable Letter of Credit:** Where the goods are exported through a middle men, the exporter may ask the importer to open a transferable letter of credit. Under a transferable letter of credit, the beneficiary will be able to transfer his right to draw a bill to a third party.
12. **Non-transferable Letter of Credit:** Every letter of credit unless stated otherwise is non-transferable. Hence the beneficiary cannot transfer such a letter of credit to a third party.
13. **Back to Back Letter of Credit:** A beneficiary of a non-transferable letter of credit may request the bank to open a new letter of credit in favour of some third party on the security of letter of credit issued in his favour, it is called a back to back letter of credit.
14. **Red Clause Letter of Credit:** If the exporter wants financial assistance in advance against his export for purchase of materials, packing etc., he can ask the importer to arrange a "Packing Credit". This packing credit is made available through the letter of credit by inserting a clause in red ink. Such a clause is called Red Clause. The negotiating banker can advance specified money to the exporter. Such accommodation is of temporary nature and is adjusted at the time of final payment.

Opening a Letter of Credit

A banker runs great risks in opening a letter of credit. Therefore, to protect his interest he must be very careful. He should take the following steps while opening a letter of credit:

1. **Application for Opening a Letter of Credit:** The applicant is required to fill an application form giving the necessary details viz.,
   (a) Amount and nature of credit required-documentary or clean, revocable etc.,
   (b) Goods to be imported along with prices, nature of invoice and other terms,
   (c) Shipping details and other documents like B/L, Invoice, Insurance policy etc.,
   (d) The details about the bill like the amount, name of the drawee, mode of delivery of documents – D/A or D.P,
   (e) Other operating instructions.

It will be accompanied with an undertaking by the applicant that he will pay the bill drawn under the letter of credit.

2. **Scrutiny of the Application:** The banker should carefully examine the application and check that all the necessary information has been given by the applicant. He should particularly see that the applicant has signed the undertaking.
3. **Taking Security:** After the banker has examined the application and is satisfied that the necessary information has been submitted, he should ask for necessary security from the applicant in the form of cash and valuables.
4. **Fixing Margin:** The banker should fix the margin to be maintained. This margin is fixed keeping in view the creditworthiness and standing of the applicant.

5. **Effective Insurance:** The banker should ask the applicant to take appropriate insurance policy to cover the risks involved. The policy should be taken in joint names of the applicant and the importer.

ADVANTAGES OF LETTER OF CREDIT

Advantages to the Exporter

(a) **Guarantee of Payment:** In case of foreign trade there is a greater risk as the exporter and importer do not know each other. Moreover, there are other risks as well. With the opening of the letter of credit the exporter is assured of the payment.

(b) **No Risk of Dishonour of Bill:** Under the letter of credit the bill drawn on the importer is accepted by the negotiating banker. Therefore, there is no risk of its being dishonoured.

(c) **No Risk of Exchange Restrictions:** The issuing banker examines carefully the restrictions imposed by the importing country before opening letter of credit. The exporter is saved of the botheration and risks of foreign exchange restrictions.

(d) **Availability of Advance Under Packing Credit Facility:** An exporter can get advance financial assistance under packing credit to finance purchase of raw materials and its conversion into finished products and other expenses.

(e) **No Risk of Loss Due to Fluctuation in Exchange Rates:** Under letter of credit the exporter is assured payment in the local currency. Therefore, he does not run the risk of fluctuation in foreign rates.

Advantages to the Importer

(a) **It Facilitates Import:** It is very difficult to import goods as the exporter does not know the importer. The issuing banker guarantees the payment to the exporter and he readily agrees to export the goods. In the absence of letter of credit the exporter may be reluctant to export goods.

(b) **No Risk in Import:** The risks involved in importing goods directly, is reduced. Under the letter of credit the importer is assured that the bill will be paid or accepted only when documents are received by the negotiating banker.

(c) **Assurance of Compliance of Foreign Exchange Rules:** The issuing banker opens the letter of credit only when it is satisfied that all the requirements of foreign exchange rules of the country of importer have been properly complied with.

(d) **Facility of Advance Payment Without any Risk:** Sometimes an exporter insists for advance payment to buy raw material and meet other costs. In such a case the importer can make advance payment by opening 'Red Clause Packing Credit' letter of credit. The negotiating banker will make advance payment, which will be adjusted while making final payment. Thus the importer is saved of the risks involved, in making advance payment for imports.

Precautions Taken by the Bank: While opening a Letter of Credit, the banker should take the following precautions:

(a) **Creditworthiness of the Party:** Before opening a Letter of Credit, the banker should examine the honesty, integrity and creditworthiness of the importer. The banker should also see the financial position of the importer in the market.

(b) **Validity of the Period:** When the bank receives an application from the importer, it should examine carefully whether the period of import licence is valid or not. In case the period of import licence is not valid under law, the banker should reject the application immediately.

(c) **Terms of Letter of Credit:** The terms and conditions of Letter of Credit must be satisfactory. If the negotiating bank fails to satisfy itself with respect to the terms of Letter of Credit, it may have no claim against the bank which issued the Letter of Credit.

Conclusion

To conclude, it is clear that the banker should take precautions and steps properly while opening a Letter of Credit. The prescribed form must be drafted by the legal expert of the bank and it will be the legal duty of the banker to examine all the documents which may be enclosed along with the application.

Questions for Discussion

1. What do you understand by a letter of credit? Explain the various kinds of travellers letter of credit.
2. Explain the various types of letters of credit issued by a bank.
3. Explain the advantages of letter of credit from the point of view of exporter and importer.
4. How is a letter of credit opened? What precautions should a banker take while making payment under a letter of credit?

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ACCOUNTS AND AUDIT OF BANKS

INTRODUCTION

A bank deals in money and the number of transactions is very large. As such there are greater chances of fraud. To check this there should be an efficient system of internal check and internal control. Banks follow continuous audit system. Therefore, there is an imperative need to have foolproof and elaborate accounting system for a bank. The accounting system of a bank has to be devised in such a manner that there is built-in-system of audit of such accounts. The Banking Regulation Act, 1949 has made provisions regarding the accounts and audit of a banking company. An important feature of bank's accounts is that the entry of a transaction must be made on the very (same) day the transaction takes place. It is necessary in order that before closure of the bank on that day the balance in the bank's books may be verified. Moreover, for a bank manager it is necessary to know day to day progress of the bank. This is possible only when the entries relating to deposits and loans are made in the concerned account on the same day.

Salient Features of Bank's Accounts

1. Number of transactions is very large.
2. Bank's account have to be maintained as per Double Entry System of Accounting.
3. Cash transactions and transfer entries occupy an important place in financial transactions of a bank.
4. All the transactions are entered in the books on the same day.
5. The transactions are recorded in the order in which they take place.
6. A bank may maintain separate books of accounts to record transactions with government and non-government customers.

7. Regular returns and statements relating to deposits and advance are to be prepared and filed.
8. Final account to be prepared in a very short period of time as such information has to be updated regularly.
9. Elaborate internal check and internal control systems have to be established.
10. An elaborate system of continuous audit has to be introduced.

Books of Account (Section 209)

The Companies Act, 1956 requires a banking company to maintain at its registered office proper books of account with respect to

1. all receipts and disbursements of money and the matters in respect of which the receipt and disbursements take place.
2. the assets and liabilities of the bank.

Where a banking company has a branch office, books of accounts relating to the transactions effected at the branch office shall be kept at the branch. At an interval of not more than 3 months, summarised accounts shall be sent to the banking company at its registered office.

Books shall Give a True and Fair View

The books shall give a true and fair view of the state of affairs of the banking company or the branch office as the case may be. The books shall also explain its transactions.

The books shall be kept on accrual basis and according to the double entry system of accounting (Section 209 (3)).

Preservation of Books

The book shall be preserved for a period of 8 years. In case of a bank which has been in existence for a period of less than 8 years, the books shall be preserved for the entire period of its existence.

Persons Responsible to Keep the Books

It is the responsibility of managing director to keep the books of account. If there is no managing director or manager, the directors shall be responsible for keeping the accounts of the bank.

Penalty

If any person fails to take proper steps to ensure compliance of these provision, he shall be punishable with imprisonment which may extend to a 6 months or with fine which may extend to Rs. 1,00 or with both. However, no person shall be liable to imprisonment unless he has committed the default wilfully.

Inspection of Books of Account

The books of account can be inspected by

(a) a director or his duly authorised agent;
(b) the Registrar of Companies;
(c) any officer authorised by the Central Government.

Books to be Maintained

The law is silent about the books to be maintained. Therefore, there is no uniformity. The books maintained by a bank differ from bank to bank. Due to lack of space, it is not possible to deal with all the books maintained by a bank. Therefore, only the important books are being discussed. A bank generally maintains the following books:

1. **Cash Book or Registers:** This is an important book of the bank. Whatever cash is deposited in a bank it is deposited through the cashier. A customer deposits the cash through a pay-in-slip. The cashier makes the entries in his cash book on the basis of a pay-in-slips. At the end of the day cashier tallies his cash balance with cash book.
2. **Cash Scroll:** To keep a check on the cashier, there is a practice to maintain cash scroll (As a part of internal check). The customer before making payment to the cashier has to get his pay-in-slip (signed) endorsed by some responsible officer of the bank. Such officer records the particulars of the pay-in-slip in the scroll register and returns the pay-in-slip to the customer after putting serial number and his initial. At the end of the day the bank manager also verifies the cash balance of the cashier with the cash scroll.

Specimen of Cash Scroll

Dr. Cr.

Sl.No.	Particulars	Amount Rs. Ps.	Sl.No.	Particulars	Amount Rs. Ps.

3. **Payment Book:** Depending upon the volume of transactions, there may be separate cashiers for receiving payment and making payment. Again, most of the banks have introduced teller system for savings bank accounts. As such, the payments up to a certain sum (say up to Rs. 3,000) are made through the officer incharge of the savings bank account counter. However, payments in excess of the above limit are made through the cashier of the bank. Similarly, payment on account of fixed deposit, current accounts are made through the cashier. The concerned officer who has to make the payment issues a token to the payee or holder. The payee or holder presents the token to the cashier who makes the payment and records the token number against the payment. At the end of the day the cashier tallies the amount paid with cash book and concerned departments against the token received.

Specimen of Cash Book Receipt Book

Sl.No.	A/c (savings, current, fixed loan, cash credit etc.)	For credit of	Deposited by	Amount Rs. Ps.

Payment Book

Sl.No.	A/c (savings, current, fixed loan, cash credit etc.)	To debit of	Paid to	Amount Rs. Ps.

4. **Token Book:** A token book or register is maintained to make payment through the cashier. The counter clerk who has to make payment gives a token to the payee (customer). He records the token number in the token book. Token is a piece of metal (brass) in round, triangular or square shape. The name of the bank and branch and its serial number is engraved on it. It is given to the customer as a token of authority to receive the payment. The cashier can come to know that the person bearing the token is authorised to receive the payment. The cashier takes back the token before making the payment. At the end of the day the tokens are counted and checked. If it is found that any token is missing, the concerned voucher is marked for non-payment on that day and the other payments made are verified.
5. **Supplementary Day Book:** At the end of the day the receipt and payment vouchers received during the day are entered in the supplementary Day Book. Credit and debit entries are recorded separately. This book is compared with the cash scroll and token book. The total of receipt column of the supplementary day book should tally with the total of the cash scroll. Similarly, the total of the payment side should also tally with the total of the token book.
6. **Ledgers:** A ledger is an important book as it contains the accounts of the customers opening their accounts with the bank. Separate ledgers are maintained for separate types of accounts, e.g., savings account ledger, current account ledger etc.

   These ledgers are maintained in alphabetical order. These ledgers are kept in the form of loose ledgers. The ledger number and the letter of the name starting first and the last name in the ledger are also marked on the ledger. When a customer wants to withdraw money from his account he is to present the cheque to the concerned counter clerk (savings A/c, current A/c etc.). The clerk makes the necessary entry in his account. In case teller system is in operation, he makes the payment also. In case no teller system is maintained, he issues a token to him after making the entry in the token register. The customer gets the payment from the cashier by surrendering his token.

   At the end of the day payments made are checked with the entries made in the customer's accounts to see that the payments have been properly debited to the customer's accounts.

7. **Loan and Advance Register:** One of the important functions of a bank is to grant loans. Earlier a bank used to give short-term loans. Now a days a bank also gives medium term and long-term as well as loans for agriculture, small scale and tiny sector industries. Separate sections deal with such loans and therefore separate ledgers are maintained for such loans. Loans are generally secured ones. However, now granting of unsecured loans has also become a common practice.

   A loan account of every borrower is opened in this register. The name, address of the borrower, period of loan, nature of advance, amount of loan sanctioned and disbursed, date of loan, security offered if any, rate of interest etc., are entered on the loan register.

8. **Bills Receivable and Payable Register:** A bank offers the facility of collection of its customer's cheques. Similarly, it also makes payment of bills on behalf of its customers. Such bills are entered in separate bills registers. For bills received an Outward Bills Collection Register is maintained. Bills payable are entered in an Inward Bills Collection Register. Date, amount of the bill, the name of the drawer, drawee, payee, place of collection and date of collection are entered in the bill collection register.

   In addition a bank maintains bills collection register, bills acceptance register, bills discounting register etc.

9. **Transfer Diary/Register:** Very often a customer makes a request for transfer of funds from one account to the other. For example, a customer may ask to transfer certain money from his account to the account of his wife in the same bank. In such a case only a transfer entry is made. The book in which such entry is made is called transfer book. At the end of the day the entries in the transfer book are verified with the entries in the accounts of the customer concerned. The relevant vouchers (generally counter foils of pay-in-slips accompanied with cheques) are marked "Transfer" with a rubber stamp.

10. **Security Register:** In case of secured loans customers deposit securities with the bank. Such securities are recorded in security register. The particulars to be recorded in the security register include, name of the borrower, amount of loan, nature of security, value of security, particulars of charge created, if any, etc.

11. **Investment Register:** A banker has also to make investment. He enters the particular of the investment made in investment register. Such particulars include, name of the institution in which investment made, nature of investment, details of the investment e.g., number of shares or nature of property, period of investment, rate of interest/dividend etc.

12. **Branch Ledger:** Inter branch transactions are recorded in branch ledger. It is kept at the head office and account of every branch is opened in this ledger.

Final Accounts

The Banking Regulation Act, 1949 has made provisions for the preparation and audit of final accounts. The provisions relating to accounts, as given in the Companies Act, 1956, are also applicable in so far as they are not against the provisions of the Banking Regulation Act, 1949.

Preparation of Balance Sheet and Profit and Loss Account (Sec. 47)

At the expiration of each calender year or at the expiration of 12 months ending with the notified date specified for the purpose by the Central Government, every banking company, in connection with its entire business and every foreign banking company in connection with the business transacted by all its branches in India, is required to prepare for the year or the period, as the case may be, a balance sheet and a profit and loss account on the last working day of the year or the period as the case may.

Form of Balance Sheet and Profit and Loss Account

The balance sheet and profit and loss account shall be prepared in the prescribed form as given in Schedule. III or as near thereto as the circumstances permit. In case of a foreign banking company the profit and loss account may be prepared on a date which shall not be earlier than 2 months of the last working day of the year.

Signing of Balance Sheet and Profit and Loss Account

The balance sheet and profit and loss account shall be signed by atleast three directors, where there are more than 3 directors and by all the directors if there are less than 3 directors.

Audit of Bank Accounts

Audit of bank accounts is very important because the number of monetary transactions is very large and there are greater chances of frauds in banks. Therefore, in banks continuous audit is done by the bank staff besides the statutory audit. Again, elaborate and efficient internal check system and internal control system are necessary for efficient audit of bank accounts. The Banking Regulation Act, 1949 has made the following provisions which are supplementary to the audit provisions of the Companies Act, 1956.

Audit of Accounts (Section 30)

The balance sheet and profit and loss account of a bank prepared in accordance with Section 29 shall be audited by a person duly qualified under the company law for the time being in force to be auditors of companies.

The Reserve Bank is also empowered to order special audit if it is satisfied that it is necessary to do so in public interest or in the interest of the company or the depositors.

An auditor is required to report on the following:

(a) Whether or not the information and explanation given were found to be satisfactory.

(b) Whether or not the transactions of the banking company were within its power.
(c) Whether or not the returns received by him from the branches were sufficient for the purpose of his audit.
(d) Whether or not the profit and loss account shows a true balance of profit and loss for the related period.
(e) Any other matter which he considers necessary to report to the shareholders.

Publication and Filing of Accounts (Section 30)

The audited balance sheet and profit and loss account alongwith the auditors report shall be published in the prescribed manner. Three such copies shall be filed as returns with the Reserve Bank within 3 months from the end of the period to which they relate.

Precautions and steps to be taken by the auditors:

1. An auditor should carefully examine the audit provisions of the Companies Act, 1956 and the Banking Regulation Act, 1949.
2. He should thoroughly examine the Memorandum and Articles Association of the bank to study the rules and regulations of the bank relating to audit and accounts of the bank.
3. The auditor should carefully examine the internal check and internal control systems of the bank.
4. The efficiency of the bank audit is dependent upon the efficiency of the internal check and internal control systems of the bank. In case he finds that the internal check and internal control systems of the bank are not dependable, he should disown his liability.
5. In particular he should thoroughly investigate the following.

A. Assets Side

1. **Cash Reserves:** He should verify the cash balance with the cash book. He should examine whether or not the bank has deposited the required cash reserve (3 % of cash and demand deposit and 6 % of time deposit) with the Reserve Bank.
2. **Liquid Assets:** The auditor should verify whether or not the bank has kept 25 % of its time and demand liabilities in the form of liquid assets as required under Section 25. In particular the auditor should see that the bank has been maintaining the increased percentage of liquid assets as and when increased by the Reserve Bank.
3. **Money at Call and Short Notice:** Money at call and short notice can only be lent to bank. As such the auditors should verify that it has not been given to non-banking companies.
4. **Investments:** There are greater chances of fraud in case of investment. The auditor should be very careful in this respect. He should ask for the schedule of investments maintained by the bank. He should see that investments have been made strictly in accordance with the provisions of the Banking Regulation Act, 1949.

He should carefully verify the title deeds of such investments and see that these are in physical or real possession of the bank. He should properly verify their valuation. These have to be valued at the face value or the market value whichever is less. He should see that the securities are free from any charge. In case the charge has been created in favour of the bank, it should be got registered under Section 134 with the Registrar.

5. **Loans and Advances:** He should carefully verify the loans and advances and the securities deposited by the borrower.

   The same procedure as applied in the case of verification of investments should be followed in the case of loans and advances also. With the permission of the bank the auditor should confirm the balance from the borrowers. In addition he should examine whether the debts are good. In case they are bad or doubtful, he should see that adequate provision has been made for them. He should see that there is adequate margin between the loan and the security. If it is inadequate he should quality his audit report accordingly.

6. **Acceptances and Endorsements:** Bills receivable should be examined carefully. He should safeguard against fictitious bills by test checking. These bills should not be overdue and should not have been renewed frequently. In case these have been renewed frequently, such bills may be doubtful. He should see proper provision has been made for rebate on bills and against bad and doubtful bills receivable.

7. **Office Premises, Furniture and other Assets:** The same general principles are also applicable to these assets. However, in the case of these assets, the auditor should see that adequate provision for depreciation has been made by the bank. These have to be valued at historical cost-basis.

B. Liability Side

1. **Capital:** He should verify the capital with the last balance sheet. He should see that it is as per the provisions of Sections 11 and 12 of the Banking Regulation Act, 1949.
2. **Reserve Fund:** He should verify the reserve fund with the last balance sheet. He should see from the profit and loss accounts that 20% of the profit have been transferred to the reserve fund before declaration of dividend by the bank.
3. **Deposits and other Accounts:** He should verify the deposits and other accounts with the help of ledgers maintained by the bank. Test checking with some pass-books may also be done.
4. **Acceptances and Endorsements:** Bills payable should be examined with the help of bills register and the bills of exchange accepted by the bank. Proper provision should have been made for rebate on bills discounted.
5. **Profit and Loss Account:** He should see that profit and loss account has been prepared in the form set out in Schedule III or near thereto as far as circumstances permit. He should check that profit has not been inflated otherwise, dividend might be paid out of capital.

Necessary explanations as required have also been given 20% of the profits have been transferred to the reserve fund as required under Sec. 17 of the Act, adequate provisions should have been made regarding depreciation.

6. **Contingent Liabilities:** Auditor should examine the contingent liabilities. He should see that adequate provision has been made by the bank for such contingent liabilities.
7. **Audit of Branches:** The auditor should examine whether or not returns from the branches regarding branch audit have been received. He should incorporate them into his audit report.

Penalty

If the auditor wilfully conceals any fact, he will be punishable with imprisonment which may extend to 3 years or with fine or with both.

Conclusion

From the above discussion, undoubtedly, we can say that, there is an imperative need to have fool proof and elaborate accounting system for a bank. The accounting system of a bank has to be devised in such a manner that there is built in system of audit of such accounts. The Banking Regulating Act, 1949 has made provisions regarding the accounts and audit of a banking company.

Questions for Discussion

1. Explain the various books maintained by a bank.
2. Explain the provisions regarding audit of bank accounts.
3. Write a note on the audit of accounts of a bank.

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Multiple Choice Questions with Answers

1. A banker should not grant loans and advances against **(c)**
(a) Unquoted shares (b) Partly paid-up shares
(c) Its own shares (d) Third party's shares

2. In the case of a life policy, the banker should see **(d)**
(a) The existence of insurable interest
(b) The surrender value
(c) The admission of age
(d) All of the above

3. The most risky document of title to goods from the banker's point of view is **(c)**
(a) Delivery order (b) Bill of lading
(c) Warehouse keeper's certificate (d) Railway receipt

4. A legal title over shares is created **(d)**
(a) By simply depositing the shares
(b) By depositing the shares along with a blank transfer
(c) By depositing shares along with a memorandum
(d) By executing a transfer deed

5. The rules framed in the Clayton's case have been incorporated in **(c)**
(a) The Banking Regulation Act
(b) The Reserve Bank of India Act
(c) The Indian Contract Act
(d) The Negotiable Instruments Act

6. The limitation period in case of a bank deposit begins from **(b)**
(a) The date on which deposit was made
(b) The date on which the demand for payment was made

(c) The date on which first withdrawal is made
(d) None of the above

7. When a debtor owes several debts to a banker and makes a payment, the right of appropriation lies with (b)

(a) The banker (b) The debtor
(c) The court (d) None of the above

8. A Garnishee order is served on A and B jointly. They maintain a joint account as well as individuals accounts with the bank. The order shall attach (c)

(a) Only the joint account of A and B
(b) Only the individual accounts of A and B
(c) The joint as well as individual accounts of A and B
(d) None of the above

9. In terms of Section 31 of the Reserve Bank of India Act, 1934 a demand draft payable to bearer may be issued only by (c)

(a) Nationalised Banks (b) Scheduled Commercial Banks
(c) Reserve Bank of India (d) Foreign Banks

10. The payment of a lost demand draft is made to the (a)

(a) Purchaser (b) Payee
(c) Nominee (d) None of the above

11. In case of original demand draft is presented after the duplicate has already been paid, the bank will (a)

(a) Pay the original demand draft as well and recover the amount from the purchaser on the strength of the indemnity bond
(b) Return with remarks "Draft reported lost, duplicate already paid will pay on collecting bank's guarantee. In case the original draft is again presented, it should be honoured."
(c) Return with the remarks payment stopped by the payee
(d) None of the above

12. Unsigned demand draft is presented for payment, the drawee branch will (b)

(a) Honour it
(b) Dishonour it since it does not have a mandate of the drawer bank to pay it.
(c) Honour it after seeking confirmation from the collecting bank
(d) Honour it if it is for small amount

13. Traveller's cheques are valid for (d)

(a) Three months (b) Six months
(c) One year (d) No limit-are valid till encashed

14. Do the banks issue traveller's cheques to non-customers also? (a)

(a) Yes
(b) No
(c) No - only people of repute
(d) No - only to people having annual income above Rs. 60,000

15. Are the traveller's cheques subject to stamp duty in India? (b)

(a) Yes
(b) No
(c) Yes, all traveller's cheques above the value of Rs. 1,000
(d) Yes, all the traveller's cheques above the value of Rs. 5,000

16. Minimum balance required to be maintained for cheque book facility (d)

(a) Rs. 100 (b) Rs. 200
(c) Rs. 500 (d) Rs. 1000

17. The committee on Banking Sector Reforms under the chairmanship of Sri. M. Narasimham was appointed in (c)

(a) 1991 (b) 1995
(c) 1998 (d) 1999

18. The Government of India passed the "Recovery of Debts due to Banks and Financial Institutions Act" in (a)

(a) 1993 (b) 1992
(c) 1994 (d) 1990

19. Where the Apellate Tribunal for recovery of debts due to banks and financial institutions is set up? (c)

(a) Chennai (b) Bangalore
(c) Mumbai (d) Kolkata

20. Documentations is (a)

(a) Proper execution of documents (b) Stamping of document
(c) Cancellation of stamps (d) None of the above

21. Collateral securities can be (d)

(a) Tangible
(b) Intangible in the shape of personal guarantee of a third party
(c) None of the above
(d) Both of the above

22. The Central Bank of India is (a)

(a) The Reserve Bank of India (b) The State Bank of India
(c) The Andhra Bank (d) Global Trust Bank

23. Stock exchange securities do not include **(d)**

(a) Debentures of companies
(b) Small debentures issued by port trusts
(c) Government promissory notes
(d) Participation certificates

24. Under Section 19(i) a banking company can hold shares in a limited company to the extent of **(c)**

(a) The paid-up capital and free reserve of that company
(b) The paid-up capital of the bank
(c) 30 % of the paid-up capital of the company or 30 % of its own paid-up capital and reserves which ever is higher
(d) 30 % of the paid-up capital of the company or 30 % of its own paid-up capital and reserves which ever is higher

25. The Definition of 'Banking' is given in **(c)**

(a) Negotiable Instrument Act, 1881
(b) RBI Act, 1934
(c) The Banking Regulation Act, 1949
(d) Contract Act

26. When was SBI established ? **(d)**

(a) April 1, 1935 (b) July 31, 1969
(c) May 5, 1955 (d) July 1, 1955

27. Presently, the number of the public sector banks in India is **(c)**

(a) 8 (b) 20
(c) 28 (d) 14

28. The maximum number of partners in a non-banking partnership firm is **(a)**

(a) 20 (b) 10
(c) 25 (d) 11

29. Which of the following banks are not commercial banks ? **(b)**

(a) Foreign Banks (b) State Co-operative Banks
(c) Private Banks (d) Regional Rural Banks

30. Regional rural banks are managed by **(c)**

(a) The Central Government (b) The RBI
(c) The Board of Directors (d) The State Government

31. Under which of the following methods of note-issue the RBI issues notes? **(c)**

(a) Fixed Fiduciary System (b) Maximum Fiduciary System
(c) Minimum Reserve System (d) Proportional Reserve System

32. Cash deposit ratio means **(a)**

(a) The percentage of cash-in-hand-balance with the Central Bank to the aggregate deposits
(b) The percentage of total cash money received as deposits by banks
(c) All the above
(d) None of the above

33. Lead Bank Scheme was introduced in **(b)**

(a) 1965 (b) 1969
(c) 1981 (d) 1992

34. A rise in the reserve ratio of banks **(c)**

(a) Will lead to an increase in the money supply
(b) Will lead to a proportionate increase in the money supply
(c) Will lead to a decrease in the money supply
(d) None of these

35. Negotiable Instruments Act contains Sections as **(b)**

(a) 137 (b) 142
(c) 138 (d) 141

36. Presently which bank is having the largest number of foreign branches? **(c)**

(a) SBI (b) Canara Bank
(c) Bank of Baroda (d) Bank of India

37. A usance bill can be drawn for a minimum period of **(a)**

(a) 1 day (b) 2 days
(c) 3 days (d) 4 days

38. Savings bank deposits are exempted from wealth tax up to **(b)**

(a) 2 lakhs (b) 5 lakhs
(c) 10 lakhs (d) 20 lakhs

39. The amount of unclaimed banker's cheques is credited to **(d)**

(a) Respective LHO (b) Respective Module
(c) Charges A/c (Misc) (d) Commission A/c

40. SBI is having maximum number of foreign offices in **(b)**

(a) U.S.A. (b) U.K.
(c) West Germany (d) Japan

41. How many export processing zones are in India? **(b)**

(a) 5 (b) 6
(c) 7 (d) 8

42. FCNR accounts can be opened and maintained as **(c)**

(a) Current Accounts
(b) Savings Bank Accounts
(c) Term Deposit Accounts
(d) Recurring Deposits

43. In the case of FCNR accounts the payment of interest is effected in **(c)**

(a) Indian Rupee
(b) Only in Pound (£)
(c) Same currency in which deposit stands
(d) Yen

44. What comprises financial statement ? **(d)**

(a) Profit and Loss Account
(b) Balance sheet
(c) Funds-flow-statement
(d) All the above

45. Profit and Loss Account represents **(d)**

(a) Position of profit on a particular date
(b) Position of profit for a given period
(c) Position of loss for a given period
(d) B and C above

46. Balance sheet is **(a)**

(a) Statement of assets and liabilities on a particular date
(b) Statement of profit and loss on a particular date
(c) Position of cash balance
(d) Statement of assets and liabilities for a particular year

47. Balance sheet analysis helps in **(d)**

(a) Ratio analysis
(b) Trend
(c) Inter-firm comparison
(d) All the above

48. Banks are required to maintain SLR under **(a)**

(a) Section 24 of the Banking Regulation Act
(b) Section 49 of the Banking Regulation Act
(c) Section 24 of RBI Act
(d) None of the above

49. CRR is required to maintain in the form of **(b)**

(a) Approved Government Securities
(b) Cash with RBI
(c) Cash with bank
(d) All the above

50. Working capital requirement depends upon (c)

(a) Level of activity (b) Types of business carried
(c) All the above (d) None of the above

51. For which of the following categories the payment can be stopped ? (b)

(a) Gift cheque (b) Cheque
(c) Bill of Exchange (d) Promissory Notes

52. The introducer is liable to the bank under the (b)

(a) Indian Penal Code (b) RBI Act
(c) Contract Act (d) NI Act

53. Cheque bearing 'Non-negotiable' crossing is endorsed to other person. In this case the endorsee becomes (a)

(a) Holder for value (b) Holder in due course
(c) Holder only (d) Endorsee only

54. Which of the following are legal tender? (c)

(a) Drafts (b) Cheques
(c) Currency notes (d) Government drafts

55. In which of the Acts specimen of the cheque, bill, promissory note is given? (d)

(a) Negotiable Instruments Act (b) Banking Regulation Act
(c) Mercantile Law (d) None of the above

56. Which of the following negotiable instruments can be crossed to the banks? (c)

(a) Cheques (b) Drafts
(c) Bills of Exchange (d) All the above

57. Which of the following can be issued payable to bearer? (a)

(a) Cheque (b) Draft
(c) Bill of Exchange (d) Demand Promissory Notes

58. Protection is available to the collecting bank for the following (d)

(a) Bill of Exchange (b) Promissory Note
(c) Usance Bills (d) Cheque

59. Crossing denotes (d)

(a) Cheque cannot be transferred by the payee.
(b) A direction to the paying bank to pay the Cheque through a bank.
(c) Cheque will be paid through clearing only.
(d) Not payable across the counter but will be credited to the account of the holder.

60. A 'Non-negotiable' crossing is a **(a)**

(a) General crossing (b) Special crossing
(c) Restricted crossing (d) Non-transferable crossing

61. A minor is admitted to the partnership firm as **(d)**

(a) Agent (b) Partner
(c) Minor (d) Beneficiary

62. Legal guardian of minor is **(b)**

(a) Nominated by the court for legal decision
(b) Appointed by the court
(c) Natural guardian
(d) Executor-administrator appointed by the court

63. A shareholder has been defined by **(b)**

(a) The Banking Regulation Act, 1949
(b) The Companies Act, 1956
(c) The Securities Contract Regulation Act, 1956
(d) Indian Contract Act

64. What is the maximum period for which a Public Limited Company can raise deposits from the public? **(c)**

(a) 12 months (b) 18 months
(c) 36 months (d) 24 months

65. Group of companies/firms/associates is defined in **(a)**

(a) Companies Act (b) Sale of Goods Act
(c) Contract Act (d) Partnership Act

66. Which of the following cheques if paid do not get statutory protection? **(b)**

(a) Bearer cheques (b) Open cheques
(c) Stolen cheques (d) All the above

67. Period of limitation for deposits starts from **(b)**

(a) Date of the cheque
(b) Date of presenting cheque on the counter
(c) Date of making deposits
(d) Date of refusal by the bank

68. Who supplies interest-charts for different maturities and for different rates of interest ? **(a)**

(a) IBA (b) RBI
(c) Government of India (d) IBRD

69. The minimum period under which a term deposit under Reinvestment Plan can be issued is (c)

(a) 24 months (b) 12 months
(c) 6 months (d) 9 months

70. Rates of Interest on deposits are determined by (c)

(a) IBA (b) Ministry of Finance
(c) RBI (d) Government of India

71. Interest on the savings bank accounts is compounded (d)

(a) Monthly (b) Yearly
(c) Quarterly (d) Half-yearly

72. What is the limitation of the number of persons in a joint savings bank account? (d)

(a) Two (b) Four
(c) Five (d) No limit

73. The minimum average balance required to be maintained in a current account to avoid payment of 'ledger fee' is (b)

(a) Rs. 500 credit (b) Rs. 1,500 credit
(c) Rs. 1,500 debit (d) Rs. 2,000 credit

74. Current account becomes dormant when there are no withdrawals for the last (b)

(a) 3 months (b) 6 months
(c) 12 months (d) 18 months

75. How do you consider Joint Hindu Family? (a)

(a) Legal entity (b) Association of persons
(c) Partnership concern (d) All the above

76. Maximum period of a usance bill considered by bank is (a)

(a) 6 months (b) 9 months
(c) 12 months (d) 24 months

77. Which of the bills has no grace period? (d)

(a) Demand bill (b) Clean bill
(c) Sight bill (d) All the above

78. After acceptance, the primary liability on a Bill of Exchange is that of (b)

(a) Payee (b) Acceptor
(c) Drawee (d) Endorsee

79. Which of the following are accommodation bills? **(a)**

(a) House bills
(b) Bills representing trading transactions
(c) Bills accepted with consideration
(d) None of the above

80. Under the Sale of Goods Act, a warehouse-keeper's certificate is a **(c)**

(a) Contract of sale (b) Contract of pledge
(c) Document of title to goods (d) Contract of lease

81. The Government derives maximum revenue from **(d)**

(a) Income tax (b) Customs
(c) Sales tax (d) Excise duty

82. Which of the following may be adjudged as insolvent? **(b)**

(a) Minor (b) Married woman
(c) Firm (d) Lunatic

83. X and Y have joint account. A Garnishee order was served on X who does not have an individual account. Bank shall **(c)**

(a) Attach the joint account
(b) Attach 50% of the joint account like attachment
(c) Not attach the joint account
(d) All the above

84. Non-registered firm cannot **(a)**

(a) Sue its partners or debtors (b) Be sued by its creditors
(c) Be sued by its own partners (d) None of the above

85. Sets of Garnishee Order **(d)**

(a) 3 (b) 5
(c) 4 (d) 2

86. Appropriation of accounts is provided in **(b)**

(a) Negotiable Instruments
(b) Banking Regulation Act, 1949
(c) Indian Contract Act, 1872
(d) All the above

87. A cheque becomes stale after **(c)**

(a) 2 months (b) 3 months
(c) 6 months (d) 12 months

88. Bank conducts Government business at its branches as an agent of (a)

(a) RBI (b) SBI
(c) Government of India (d) None of the above

89. The validity period of a challan/bill passed by a Treasury Officer is for (b)

(a) 7 days (b) 10 days
(c) 14 days (d) 20 days

90. A draft for Rs. 18,000 is issued in which series? (c)

(a) OT (b) TT
(c) OL (d) OM

91. Minimum period for which a locker can be hired is (c)

(a) 1 week (b) 3 months
(c) 6 months (d) 12 months

92. When a fixed deposit receipt is kept with the bank for its safety, it is known as (a)

(a) Safe custody (b) Safe deposit
(c) Locker (d) Valid safe deposit

93. Rupee Traveller Cheques are for a period of (d)

(a) 6 months (b) 12 months
(c) 24 months (d) Unlimited

94. India's 7th Export Processing Zone is being set up at (c)

(a) Mumbai (b) Visakhapatnam
(c) Cochin (d) Chennai

95. Gilt-edged securities are (b)

(a) Shares of a private limited company
(b) First-class Government securities
(c) Shares of a company
(d) None of the above

96. Certificate of Deposits can be issued for a minimum period of (b)

(a) 45 days (b) 3 months
(c) 6 months (d) 1 year

97. Telegraphic Transfer Receipt is a (c)

(a) Bearer instrument (b) Order instrument
(c) Non-negotiable (d) Business letter

98. A gift cheque is (c)

(a) A negotiable instrument
(b) An order instrument

(c) Simple receipt
(d) A quasi-negotiable instrument

99. If a payee of a mail transfer does not maintain account **(a)**
(a) Banker's cheque will be issued
(b) M. T. will be credited to Sundry Deposit Account
(c) Draft will be issued
(d) New account will be opened

100. Which of the following can delegate his power to a third person? **(c)**
(a) Liquidator (b) Executor
(c) Individual (d) Partner

101. Overdue interest for all types of deposits can be paid in cash to **(d)**
(a) Minor
(b) Guardian
(c) Depositor
(d) Legal heirs of a deceased depositor

102. Which of the following has been withdrawn? **(b)**
(a) Credit Monitoring System (b) Credit Authorisation Scheme
(c) Credit Monitoring Arrangement (d) None of the above

103. An executor of deceased account is appointed under **(c)**
(a) Trust (b) Court
(c) Will (d) Family tradition

104. Service area approach has been launched from **(b)**
(a) January 1, 1990 (b) April 1, 1989
(c) April 1, 1992 (d) July 1, 1992

105. While granting an overdraft against the security of life insurance policy, the advance value is computed on the basis of **(c)**
(a) Total amount of the policy (b) Paid-up value of the policy
(c) Surrender value of the policy (d) None of the above

106. Book-debits of a company can be charged to the bank by way of **(a)**
(a) Hypothecation (b) Pledge
(c) Mortgage (d) Lien

107. Which of the following has issued Master shares? **(c)**
(a) RBI (b) SBI
(c) UTI (d) LIC

108. Which of the following schedules of Indian constitution deals with banking? (d)

(a) 5th (b) 6th
(c) 7th (d) 8th

109. Is there any limit for a currency transfer? (c)

(a) 10 lakhs (b) 25 lakhs
(c) No limit (d) 1 crore

110. Currency notes deposited in the currency chest are the property of (b)

(a) Respective bank (b) RBI
(c) SBI (d) Government of India

111. The minimum amount to effect a currency transfer is (c)

(a) Rs. 500
(b) Rs. 2,000
(c) Rs. 1,000 withdrawal deposit Rs. 500
(d) Rs. 5,000 multiples of Rs. 1,000

112. Relationship between the RBI and the bank maintaining currency chest will be of (c)

(a) Trustee and beneficiary (b) Principal and agent
(c) Licensor and licensee (d) Creditor and debitor

113. Indian currency means (a)

(a) One-rupee notes and coins under Indian Coinage Act, 1906
(b) Notes only
(c) Coins only
(d) None of the above

114. Which of the following notes cannot be exchanged? (b)

(a) Solid notes (b) Mismatched notes
(c) Mutilated notes (d) All the above

115. Daily operations on the currency chest are advised to (d)

(a) RBI (b) Concerned bank
(c) Main branch of the district (d) Through link branch to RBI

116. Suprious coins detected at the counter are sent to (a)

(a) Mint (b) Government of India
(c) RBI (d) IBRD

117. Signature on Re. 1 note is made by the Finance Secretary but on the other notes by (c)

(a) Prime Minister
(b) President of India

(c) Governor of Reserve Bank of India
(d) Finance Minister

118. On a cheque instead of two parallel lines only bank's name is written. It is a (d)

(a) General crossing (b) No crossing
(c) Payable to bearer (d) Special crossing

119. A holder in due course of a cheque does not get protection from (b)

(a) Irregularity of endorsement (b) Without consideration
(c) Default in the title (d) All the above

120. What is the minimum period of reinvestment deposits? (d)

(a) 1 month (b) 2 months
(c) 3 months (d) 6 months

121. Which of the following is a borrowing facility/loan advance? (a)

(a) Term finance
(b) Performance guarantee
(c) Bill received under letter of credit
(d) All the above

122. Fixed assets ratio means (b)

(a) Fixed assets to paid-up capital
(b) Net fixed assets to long-term funds
(c) Net worth
(d) None of the above

123. A decline in the current ratio and liquidity ratio indicates (c)

(a) Sound position (b) Solvency
(c) Over trading (d) Off shore

124. Marginal cost means (a)

(a) Raw-material selling expenses and other variable expenses
(b) Prime cost
(c) Margin of sales
(d) None of the above

125. Assignment means transfer of (d)

(a) Ownership only (b) Possession only
(c) The policy-holder only (d) A debit/right/property only

126. Margin of surrender value for the purpose of bank loan is retained to the extent of (c)

(a) 5 % (b) 8 %
(c) 10 % (d) 15 %

127. Selective credit control covers (d)

(a) Margin (b) Interest
(c) Level of credit (d) All the above

128. Under which provisions is Selective credit control governed? (c)

(a) Section 49 of the Banking Regulation Act
(b) Section 3 of the Public Debt Act
(c) Section 21 of the RBI Act
(d) Section 131 of the Negotiable Instrument Act

129. Pledge of advance is made against (b)

(a) Gold (b) Commodities
(c) Coins and notes (d) All the above

130. What rate of interest is charged on the advances made against Duty Draw Back Scheme? (d)

(a) Same as of export advance (b) Same as on working capital
(c) Same as of export refinance (d) Nil

131. Contract of insurance is a contract of (b)

(a) Agency (b) Indemnity
(c) Bailment (d) Guarantee

132. The insurance policy over the security is arranged for in the name of the (a)

(a) Borrower and endorsed in favour of the bank
(b) Bank
(c) Borrower
(d) None of the above

133. Bank becomes pledge over the (c)

(a) Supply bills (b) Demand bills
(c) Import bills (d) Export bills

134. Who registers the firm? (c)

(a) Deputy Commissioner (b) Bank
(c) Registrar of Firms (d) Registrar of Companies

135. Which of the following are covered under pledge? (d)

(a) Actual delivery of the goods
(b) Factory type pledge
(c) Constructive delivery of the goods
(d) All the above

136. Cash credit accounts are closed (b)

(a) On the death of the agent
(b) On the death of the principal
(c) On the death of the Managing Director of the company
(d) None of the above

137. Industrial co-operatives covered under SSI can raise loan without ceiling. The loan will be refinanced by (c)

(a) IDBI (b) RBI
(c) NABARD (d) DICGC

138. What is the minimum period of medium and long-term loans? (b)

(a) 12 months (b) 18 months
(c) 24 months (d) 36 months

139. Which bank does not belong to State Bank Group? (b)

(a) State Bank of Indore
(b) Banaras State Bank
(c) State Bank of Bikaner and Jaipur
(d) State Bank of Patiala

140. For which are the reserves maintained before issuing the following? (d)

(a) One rupee notes (b) One rupee coins
(c) All notes and coins (d) RBI notes

141. At the time of first nationalisation which bank had the highest deposits? (c)

(a) Punjab National Bank (b) Canara Bank
(c) Central Bank of India (d) Bank of India

142. New branch in rural and semi-urban area should cover an average population of over (a)

(a) 13,000 (b) 17,000
(c) 20,000 (d) 25,000

143. The exchange rate is kept the same in all parts of the market by (c)

(a) Speculation (b) Interest arbitrage
(c) Exchange arbitrage (d) Hedging

144. If all the banks in an economy are nationalised and converted into a monopoly bank, total deposit creation **(c)**

(a) Will increase
(b) Will decrease
(c) Will neither increase nor decrease
(d) All the above

145. The purpose of international trade is **(d)**

(a) Need for exports
(b) To encourage exports
(c) To promote international understanding
(d) To increase income of participation countries

146. The power of banks to create credit depends on **(a)**

(a) Amount of cash with them and the safe ratio
(b) Safe ratio only
(c) Amount of cash with them only
(d) None of the above

147. The money the banker creates is **(b)**

(a) His asset (b) His liability
(c) Both his asset and liability (d) None of the above

148. High rate of investment may **(b)**

(a) Reduce the amount of credit creation
(b) Create better chances for the credit creation
(c) Not affect the amount of credit in any way
(d) Lead to any of the above-mentioned occurrences

149. The 'monetary base for credit expansion' consists of **(a)**

(a) The total value of 'high-powered money'
(b) The demand and time deposit liabilities
(c) The size of the deficit in the government's budget
(d) All of these

150. A rise in the reserve ratio of banks **(c)**

(a) Will lead to an increase in the money supply
(b) Will lead to a proportionate increase in the money
(c) Will lead to a decrease in the money supply
(d) None of these

151. The largest nationalised bank of India is **(b)**

(a) Central Bank of India (b) State Bank of India
(c) Bank of India (d) Reserve Bank of India

152. Commercial banks influence money supply through **(d)**

(a) Printing of one rupee notes

(b) Augmentation of savings and time deposits

(c) Provision of high denomination notes

(d) Creation of demand deposits

153. Which institution grants financial assistance exclusively to the private sector industries in our country? **(c)**

(a) Unit Trust of India

(b) Life Insurance Corporation of India

(c) Industrial Credit and Investment Corporation of India

(d) Industrial Finance Corporation of India

154. Who grants subsidy? **(a)**

(a) Government of India (b) State Government

(c) RBI (d) SBI

155. Minimum cash reserves fixed by law constitute **(a)**

(a) A percentage of aggregate deposits of the bank

(b) A percentage of aggregate loans and advances of the bank

(c) A percentage of capital and reserves of the bank

(d) None of the above statements is correct

156. The difference between the correct market value and the loan value of a given security in banking terms, is known as **(c)**

(a) The collateral value

(b) The security value differential

(c) The margin

(d) All the above

157. An increase in bank rate, other things being equal, will result into **(b)**

(a) A decline in the cost of credit including greater and the demand for borrowing

(b) An increase in the cost of credit discouraging demand for credit

(c) No change in the cost of credit and the demand for borrowing

(d) Cost of credit has no relationship with demand for borrowing

158. Inward remittances by foreign steamship and airlines companies to finance their operating expenses in the country are shown under **(a)**

(a) The credit side of the current account of balance of payment

(b) The debit side of the current account of balance of payment

(c) The credit side of the capital/account of balance of payment
(d) The debit side of the capital account of balance of payment.

159. How many copies of bank's lien are sent to the company? (b)
(a) One (b) Two
(c) Three (d) Four

160. Find out the correct statement (c)
(a) 'Selective credit controls are superfluous in general monetary management
(b) 'Selective credit controls have inverse relationship with quantitative instruments of credit control
(c) 'Selective credit controls are complimentary to quantitative instruments of credit control
(d) None of above statements is correct

161. Bank rate policy as a weapon of credit control has emerged from the Central Bank's function as (b)
(a) Bank of issue (b) Lender of the last resort
(c) Banker's bank (d) All the above

162. Open market operations are mainly used as (b)
(a) A fiscal device which assists Government borrowing
(b) A monetary measure to regulate quantity of money in circulation and the cash reserves of the commercial banks
(c) A measure to counteract extreme trends in business
(d) A measure to influence the balance of payments position

163. The variable reserve ratio has tremendous possibilities of effective credit control in (a)
(a) Under-developed economies
(b) Developed economies
(c) Both developed and under-developed economies
(d) Neither developed nor under-developed economies

164. Discount rate on certificate of deposits is decided by (d)
(a) RBI (b) IBA
(c) SBI (d) None of these

165. Sources to meet working capital are (d)
(a) Net working capital or liquid surplus
(b) Sundry creditors and advance payment received
(c) Bank finance for working capital
(d) All the above jointly

166. What is Debt Equity Ratio? **(a)**

(a) Ratio of long-term borrowing to tangible net worth
(b) Ratio of current assets to own tangible net worth
(c) Ratio of fixed assets to tangible net worth
(d) None of the above

167. Intangible assets are **(d)**

(a) Preliminary expenses
(b) Patents, copyright, goodwill
(c) Losses which cannot be reduced from share capital
(d) All the above

168. What is Current Ratio? **(c)**

(a) Ratio of total assets to total liabilities
(b) Earning capacity of unit
(c) Ratio of current assets to current liabilities
(d) None of the above

169. Current Ratio represents **(a)**

(a) Ability of the unit to meet its current liabilities out of current assets
(b) Ability of easy profit
(c) Ability of the unit to pay instalments of term-loan
(d) None of the above

170. Liability-side of the balance-sheet comprises **(d)**

(a) Capital and reserve (b) Long-term liabilities
(c) Current liabilities (d) All the above

171. The 15th day of a month is known as **(a)**

(a) Customer's Day (b) Complaints Day
(c) Holiday (d) None of the above

172. Inter-bank participation certificates are issued on the recommendations of which committee? **(b)**

(a) Ghosh (b) Vaghul
(c) Chakravarthy (d) Narasimhan

173. A transferable letter of credit cannot be transferred more than **(a)**

(a) Once (b) Twice
(c) Three times (d) Four times

174. If the word irrevocable or revocable is not indicated in a letter of credit, then the credit shall be deemed as (c)

(a) Revolving credit (b) Standby credit
(c) Revocable credit (d) Irrevocable credit

175. Service charges on Foreign Letter of Credit are fixed by (b)

(a) IBA (b) FEDAI
(c) RBI (d) IBRD

176. Exchange portion of Demand Bills purchased is credited to which account? (d)

(a) Discount (b) Commission
(c) Exchange (d) Interest

177. Unclaimed pass-books lying with the bank may be cancelled and destroyed after how many years? (b)

(a) 2 (b) 3
(c) 5 (d) 10

178. The Government has allowed certain remission on which of the following bills? (a)

(a) Usance (b) Demand
(c) Exchange (d) All the above

179. Export Credit Packing Advances sanctioned to SSI exporters are covered under the credit guarantee scheme of (b)

(a) DICGC (b) ECGC
(c) DRI (d) None of the above

180. Total investment in a company is (b)

(a) Net fixed assets
(b) Shareholder's funds plus term-liabilities
(c) The total assets of the company
(d) None of the above

181. The Deposit Insurance Credit Guarantee Scheme was formed on (c)

(a) July 1, 1975 (b) January 1, 1952
(c) January 1, 1962 (d) January 1, 1991

182. At present (March 1998) the maximum bank's deposit interest rate is (c)

(a) 9 % (b) 10 %
(c) 11 % (d) 12 %

183. Banker's cheque is valid from the issue date for **(b)**
(a) 3 months (b) 6 months
(c) 12 months (d) 24 months

184. Remittance means **(d)**
(a) Despatch of issuable notes (b) Despatch of solid notes
(c) Despatch of coins (d) All the above

185. For which of the following, minor is nor eligible for **(d)**
(a) Making a will
(b) Taking a locker in his name
(c) Appointing nominee of a locker
(d) All the above

186. A branch can be kept opened for Government business on a public holiday on the orders of the **(a)**
(a) Collector (b) Branch Manager
(c) Governor of the RBI (d) Prime Minister

187. Who pays commission to banks for conducting Government business? **(c)**
(a) Government of India
(b) State Government
(c) RBI
(d) Central and State Governments

188. Which country has the lowest rate of interest on advances? **(b)**
(a) India (b) Switzerland
(c) Japan (d) USA

189. Concept of Banking Secrecy was converted into law in **(d)**
(a) 1924 (b) 1927
(c) 1930 (d) 1934

190. The shares must be transferred in favour of the bank if the advance exceeds **(c)**
(a) 1 lakh (b) 2 lakhs
(c) 3 lakhs (d) 5 lakhs

191. Bank's charge over boats is registered with **(c)**
(a) RBI (b) SBI
(c) Port authorities (d) Government of India

192. In April 2000 India's trade deficit (exports and imports) was $ billion **(b)**
(a) 220.4 (b) 112.3
(c) 467.8 (d) 100.5

193. With regard to the export policy of the Government of India, find out the correct statement (c)

(a) All commodities can be exported without licence
(b) Export licences are required for only a few items
(c) Export licences are required for all items
(d) All the above

194. We can open a savings bank account in the sole name of a minor if he completes age of (b)

(a) 6 (b) 10
(c) 18 (d) 21

195. The Banking Regulations Act, 1949 was enacted to (c)

(a) Nationalise the banks (b) Open regional rural banks
(c) Consolidate and amend the laws relating to banking companies
(d) Inviting foreign banks

196. The Banking Regulation Act was implemented on (c)

(a) September 6, 1949 (b) April 1, 1949
(c) March 16, 1949 (d) March 31, 1949

197. The fourteen banks were nationalised on (a)

(a) July 19, 1969 (b) June 1, 1969
(c) June 16, 1969 (d) July 1, 1969

198. The banks were nationalised with the motive to (d)

(a) Develop the country economically
(b) Give priority to neglected sectors and exports
(c) Extend finances to weak and backward areas
(d) All the above

199. The fourteen banks which were nationalised were having total deposits (c)

(a) Rs. 10 crores or above (b) Rs. 25 crores or above
(c) Rs. 50 crores or above (d) Rs. 75 crores or above

200. The remaining six banks were nationalised on (a)

(a) April 15, 1980 (b) April 5, 1980
(c) April 1, 1980 (d) none of the above

201. The six more banks which were nationalised had demand deposits and liabilities of (d)

(a) Rs. 50 crores or above (b) Rs. 100 crores or above
(c) Rs. 150 crores or above (d) Rs. 200 crores or above

202. The Lead Bank Scheme was introduced in **(b)**

(a) 1968 (b) 1969
(c) 1974 (d) 1976

203. The Lead Bank Scheme was introduced on the basis of recommendations of **(c)**

(a) Reserve Bank
(b) NABARD
(c) Study group appointed by National Credit Council under the chairmanship of Prof. D.R. Gadgil
(d) None of the above

204. Under the Lead Bank Scheme all the districts in the country have been allocated amongst **(c)**

(a) Land development banks
(b) District co-operative banks
(c) 22 public sector banks and three private sector banks
(d) None of the above

205. The main functions of Lead Banks are **(d)**

(a) Surveying the resources and potential for banking development in its district
(b) Assisting the small units and small borrowers and other primary lending agencies
(c) Maintaining contacts and liasion with government and semi-government agencies
(d) All the above

206. The Lead Bank in the district **(d)**

(a) Does not have monopoly in the district
(b) Identifies the underbanked areas for opening its branches in the district
(c) Formulates the credit plans for all the banks in the district
(d) All the above

207. The Lead Bank Scheme was launched towards the end of 1969 for the following objectives **(d)**

(a) Extension of institutional finance facilities to neglected areas
(b) Extension of credit to priority sector
(c) Integration of various elements of development, namely, infrastructure extension and credit
(d) All the above

208. The Service Area Approach is in force since **(d)**
(a) 1975 (b) 1978
(c) 1985 (d) 1988

209. The Industrial Development Bank of India was set up in **(a)**
(a) 1964 (b) 1969
(c) 1976 (d) 1981

210. Industrial Development Bank extends refinance for **(b)**
(a) Small scale industrial units (b) Medium industrial units
(c) Both the above (d) None of the above

211. Small Industries Development Bank, set up by an Act of parliament commenced operating on **(a)**
(a) January 1, 1990 (b) March 1, 1990
(c) April 1, 1990 (d) April 2, 1990

212. Small Industries Development Bank of India is wholly subsidiary of **(d)**
(a) RBI (b) Exim Bank
(c) NABARD (d) IDBI

213. Small Industries Development Bank of India's Single Window scheme means that a borrower is granted **(a)**
(a) Both term loan for fixed assets and loan for working capital through the same agency, namely, SFCs or Commercial Banks
(b) Both term and working capital through SIDBI itself
(c) Both term loan and working capital through IDBI
(d) None of the above

214. National Equity Fund Scheme of SIDBI provides **(c)**
(a) Equity type of support to small sector
(b) Rehabilitation of viable sick units in the SSI sector
(c) Both of the above
(d) None of the above

215. The Industrial Finance Corporation of India was set up in **(c)**
(a) March 1948 (b) April 1948
(c) July 1948 (d) October 1948

216. IFCI extends financial assistance for **(d)**
(a) Setting new projects
(b) Expansion of existing units
(c) Diversification, renovation and modernisation of existing unit
(d) All the above

217. The Industrial Finance Corporation of India provides loans to **(c)**

(a) Industries in public sector only
(b) Industries set up for export promotion
(c) Joint-stock companies in the public or private or joint sector or co-operative sector
(d) None of the above

218. Industrial Credit and Investment Corporation of India was set up in **(d)**

(a) 1948 (b) 1950
(c) 1951 (d) 1955

219. The large part of the equity capital is held by **(a)**

(a) Public sector institutions such as banks, LIC
(b) World Bank
(c) Reserve Bank
(d) None of the above

220. ICICI provides financial assistance to **(d)**

(a) Small-scale industries (b) Medium-scale industries
(c) Large-scale industries (d) All the above

221. ICICI provides assistance by way of **(d)**

(a) Long and medium-term loans and equity participation
(b) Guaranteeing rupee and foreign currency loans raised from other sources
(c) Underwriting issues of shares and debentures
(d) All the above

222. The most significant feature of ICICI's operations is **(d)**

(a) The foreign currency loans sanctioned by it
(b) To channelise World Bank funds to industry in India and to build capital market in India
(c) The refinance facilities extended by it
(d) Both (a) and (b)

223. The State Financial Corporations have been set up under **(a)**

(a) State Financial Corporation Act, 1951
(b) Reserve Bank of India Act
(c) Banking Regulation Act
(d) Companies Act, 1956

224. State Financial Corporation extend financial assistance to **(d)**

(a) Proprietory and partnership firms
(b) Public and private limited companies and co-operative societies
(c) Hindu undivided family concerns
(d) All the above

225. The loans granted by SFC's are refinanced by **(d)**

(a) IDBI (b) SIDBI
(c) RBI (d) both (a) and (b)

226. NABARD provides refinance to **(d)**

(a) Scheduled commercial banks (b) Co-operative banks
(c) Regional rural banks (d) All the above

227. NABARD provides refinance assistance for **(d)**

(a) Promotion of agriculture
(b) Promotion of small scale industries
(c) Cottage and village industries
(d) All the above

228. The Export-Import Bank of India was set up in **(c)**

(a) July 1969 (b) April 1970
(c) January 1982 (d) April 1982

229. Exim Bank also provides **(d)**

(a) Refinance facilities
(b) Consultancy and technology services
(c) Services of finding foreign markets for exporters
(d) All the above

230. Exim Bank concentrates on **(a)**

(a) Medium-term financing
(b) Short-term financing
(c) Short and medium-term financing
(d) Short and long-term financing

231. Exim Bank extends facility of **(d)**

(a) Rediscounting of foreign bills of commercial banks
(b) Advisory services to the exporters
(c) Research and market surveys
(d) All the above

232. The Regional Rural Banks were set up in **(d)**

(a) January 1, 1975 (b) March 11, 1975
(c) April 1, 1975 (d) October 2, 1975

233. Regional Rural Banks were set up vide **(d)**

(a) Reserve Bank of India Act
(b) Regional Rural Banks Act, 1976
(c) NABARD Act
(d) None of the above

234. Regional Rural Banks carry on normal banking business as defined in **(b)**

(a) Reserve Bank of India Act
(b) Banking Regulation Act, 1949
(c) Regional Rural Bank Act, 1976
(d) Companies Act, 1956

235. Regional Rural Banks are classified under **(d)**

(a) Land Developments Banks (b) Co-operative Banks
(c) Commercial Banks (d) Public Sector Banks

236. The chairman of Regional Rural Bank is appointed by **(d)**

(a) State Government
(b) Reserve Bank of India
(c) Central Government
(d) Sponsoring bank in consultation with NABARD

237. The issued capital of the Regional Rural Banks was to be subscribed as under **(d)**

(a) Fifty per cent by Central Government
(b) Fifty per cent by State Government
(c) Thirty per cent by sponsoring bank
(d) All the above

238. Each Regional Rural Bank is managed by **(a)**

(a) Board of Directors (b) Reserve Bank
(c) Sponsoring commercial bank (d) None of the above

239. Regional Rural Banks have been permitted to pay ½ % additional interest on **(c)**

(a) All deposits accounts except current deposits
(b) All deposits accounts including current deposits
(c) Savings accounts and time deposits of less than three years
(d) None of the above

240. Land mortgage banks are renamed since 1996-97 as **(a)**

(a) Land Development Banks (b) Co-operative Central Banks
(c) NABARD (d) Lead Bank

241. Co-operative banks are **(a)**

(a) Private sector banks (b) Public sector banks
(c) Joint-sector banks (d) None of the above

242. Certificate of Deposit can be issued by **(d)**

(a) Reserve Bank, NABARD and Exim Bank only
(b) Commercial banks and term lending institutions
(c) Scheduled commercial banks excluding regional rural banks
(d) All the above

243. The minimum acceptable amount under the Scheme of Certificate of Deposit is **(d)**

(a) Rs. 5 lakhs (b) Rs. 10 lakhs
(c) Rs. 20 lakhs (d) Rs. 25 lakhs

244. Banks are promised to grant loans against certificates of deposits **(b)**

(a) Yes
(b) No
(c) Yes, only to NRI
(d) Yes, only up to 50 % of the face value

245. Commercial paper may be issued for a period of **(b)**

(a) 90 days (b) 91 to 180 days
(c) 181 days to one year (d) One year or two years

246. The commercial paper can be issued to raise deposits by **(a)**

(a) Commercial banks (b) Reserve Bank of India
(c) IDBI (d) Every non-banking company

247. The aggregate amount of commercial paper issued by a bank should not exceed **(c)**

(a) Rs. 25 crores
(b) 5 % of its demand and the liabilities
(c) 75 % of its fund based working capital limits
(d) 1 % of its net worth

248. The Stock Exchange Board of India was set up by a Special Act in **(a)**

(a) 1988 (b) 1989
(c) 1987 (d) 1990

249. Discount and Finance House of India Limited was set up by RBI in **(a)**

(a) 1988 (b) 1989
(c) 1987 (d) 1990

250. Demand deposits mean **(a)**

(a) Deposits withdrawable on demand by the depositor
(b) Current deposits
(c) Fixed deposits
(d) Short deposits

251. Time deposits means **(a)**

(a) The deposits which are lent to bank for a fixed period
(b) Time deposits include over due fixed deposits
(c) Time deposits do not include recurring deposits as well
(d) Time deposits do not include deposits under Home Loan Account Scheme

252. Fixed deposits are for the bank **(c)**

(a) Demand liability (b) Fixed asset
(c) Time liability (d) None of the above

253. Home Loan Account can be opened by any one in **(d)**

(a) His own name (b) The name of the spouse
(c) The name of the minor (d) All the above

254. The minimum amount of contribution to open a Home Loan Account **(d)**

(a) Rs. 5 (b) Rs. 10
(c) Rs. 20 (d) Rs. 30

255. The Negotiable Instruments Act deals with **(b)**

(a) Cheques, demand drafts, banker's cheques
(b) Promissory notes, bills of exchange and cheques
(c) Bills of exchange, cheques and demand drafts
(d) Cheques, demand drafts and saving bank withdrawal forms

256. Which of the following are considered negotiable instruments per custom? **(d)**

(a) Railway receipts (b) Demand drafts
(c) None of the above (d) Both the above

257. The term "escrow" means **(a)**

(a) Conditional delivery of an instrument
(b) An inchoate instrument
(c) Kite flying
(d) Window dressing

258. Hundies are **(a)**

(a) Negotiable instruments by customs and usages
(b) Negotiable instruments by definition
(c) None of the above
(d) Both the above

259. A person can not be called a holder of an instrument if he has obtained the instrument **(d)**

(a) By unlawful means
(b) For an illegal consideration
(c) By fraud, coercion, duress or fear
(d) All of these

260. The relationship between a banker and a customer is **(c)**

(a) That of a debtor and a creditor
(b) That of a creditor and a debtor
(c) Primarily that of a debtor and a creditor
(d) (a) and (b) together

261. To constitute a person as a customer **(b)**

(a) There must be a single transaction of any nature
(b) There must be some sort of an account
(c) There must be frequency of transactions
(d) There must be dealing of a banking nature

262. The banker has a lien on **(a)**

(a) Bonds given for collection
(b) Bonds given for safe custody
(c) Bonds left by mistake
(d) (a) and (b) together

263. The banker has a statutory obligation to **(a)**

(a) Honour customers cheques
(b) Exercise lien
(c) Maintain secrecy of his customer's accounts
(d) Honour customer's bills

264. In executing the standing instructions, there exists a relationship of **(d)**

(a) Trustee and beneficiary
(b) Debtor and creditor
(c) Bailee and bailor
(d) Agent and principal

265. The most undesirable customer is **(d)**

(a) A minor
(b) A married woman
(c) An unregistered firm
(d) An undischarged bankrupt

266. Contracts by lunatics in India **(c)**

(a) Always valid (b) Always void
(c) Always voidable (d) At times voidable

267. The best procedure for opening an account in the name of a minor x and the guardian y would be under the style **(c)**

(a) "x" account (b) "x" account - minor
(c) "y" in trust for x (d) "y" account

268. The balance of joint account in the name of x, y and z should be paid on the death of x **(d)**

(a) To the legal representative of x
(b) To y and z
(c) To y or z
(d) To the legal representatives of x, y and z

269. A customer's letter of instructions, without any stamp, in connection with the operations of his account is known as **(a)**

(a) Mandate (b) Probate
(c) Power of attorney (d) Authority letter

270. The most important feature of negotiable instrument is **(d)**

(a) Free transfer (b) Transfer free from defects
(c) Right to issue (d) (a) and (b) together

271. The document drawn by a debtor on the creditor agreeing to pay a certain sum is called **(a)**

(a) Promissory note (b) Cheque
(c) Bill of exchange (d) Draft

272. The following one is a negotiable instrument, negotiable by usage or custom **(b)**

(a) Bill of exchange (b) Share warrant
(c) Accommodation bill (d) Promissory note

273. In the case of negotiable instrument, the following person generally gets a good title **(c)**

(a) Finder of the lost instrument (b) Holder of a stolen instrument
(c) Holder-in-due course (d) Holder of a forged instrument

274. A cheque which is not crossed is called **(a)**

(a) Open cheque (b) Bearer cheque
(c) Uncrossed cheque (d) Order cheque

275. The safest form of crossing is **(a)**

(a) Account payee crossing (b) General crossing
(c) Special crossing (d) Double crossing

276. The following one is absolutely essential for a special crossing **(d)**

(a) Two parallel transverse lines (b) Words "And company"
(c) Words "Not negotiable" (d) Name of a banker

277. Not negotiable crossing is a warning to the **(c)**

(a) Paying banker (b) Collecting banker
(c) Holder (d) (a) and (b) together

278. A not negotiable crossing restricts what of the cheque **(b)**

(a) Transferability
(b) Negotiability
(c) Neither transferability nor negotiability
(d) Both transferability and negotiability

279. An order cheque can be converted into a bearer cheque by means of **(c)**

(a) Sans recourse endorsement (b) Special endorsement
(c) Blank endorsement (d) Sans frais endorsement

280. Endorsement signifies that the **(d)**

(a) Endorser has got a good title
(b) Endorser's signature is genuine
(c) Previous endorsements are genuine
(d) All the above

281. One of the following endorsements is not a valid one **(c)**

(a) Conditional endorsement (b) Restrictive endorsement
(c) Partial endorsement (d) Facultative endorsement

282. Negotiability gives to the transferee what title of the transferor **(a)**

(a) Better title (b) No title
(c) The same title (d) No better title

283. To get statutory protection, the paying banker must make **(c)**

(a) Payment to a holder
(b) Payment in due course
(c) Payment to a holder in due course
(d) Payment to a drawee in case of need

284. The best answer for returning a cheque for want of funds in the account is (d)

(a) Refer to drawer
(b) Not provided for
(c) Exceeds arrangement
(d) Not sufficient funds

285. When the amount stated in words and figures differs, the banker (b)

(a) Can honour the amount in figures
(b) Can honour the amount in words
(c) Can honour the smaller amount
(d) Can dishonour it

286. When a Garnishee order is issued by the court attaching the account of a customer, the banker is called (a)

(a) Garnishee
(b) Garnishor
(c) Judgement creditor
(d) Judgement debtor

287. A collecting banker is given protection only when he collects (a)

(a) A crossed cheque
(b) An order cheque
(c) A bearer cheque
(d) A mutilated cheque

288. A collecting banker is given the statutory protection only when he acts as (a)

(a) An agent
(b) A holder
(c) A holder for value
(d) A holder in due course

289. Collecting a cheque payable to the firm to the private account of a partner without enquiry constitutes (d)

(a) Gross negligence
(b) Contributory negligence
(c) Negligence under remote grounds
(d) Negligence connected with immediate collection of a cheque

290. Bankers undertake the duty of collection of cheques and bills because (d)

(a) Section 131 of the Negotiable Instruments Act compels them to do so
(b) Section 85 of the Negotiable Instruments Act compels them to do so
(c) Collection is a must for a crossed cheque
(d) They want to do it as a service

291. The most risky charge from a banker's point of view is (b)

(a) Pledge
(b) Hypothecation
(c) Mortgage
(d) Lien

292. The most convenient charge from an industrialist's point of view is (c)

(a) Equitable mortgage
(b) Legal mortgage
(c) Hypothecation
(d) Lien

293. An equitable mortgage can be created in respect of **(b)**

(a) Government securities (b) Real estate
(c) Wheat in a godown (d) Life policies

294. A charge where there is neither the transfer of ownership nor the possession is called **(a)**

(a) Hypothecation (b) Lien
(c) Pledge (d) Mortgage

295. The liability of the mortgager is gradually reduced in the case of **(c)**

(a) Equitable mortgage (b) Legal mortgage
(c) Usufructuary mortgage (d) Conditional mortgage

296. Real estate is not popular as a security because of **(a)**

(a) Difficulties in ascertaining the title
(b) Difficulties in its valuation
(c) The absence of ready market
(d) Long-term nature of the loan

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Key Terms

1. **Bank:** A bank is a commercial institution which deals with money and credit.
2. **Co-operative banks:** Co-operative banks are a group of financial institutions organised under the provisions of the Co-operative Societies Act of the states.
3. **Commercial banks:** The banks which perform all kinds of banking business and generally finance trade and commerce are called "commercial banks."
4. **Exchange banks:** Banks which deal in foreign exchange and specialise in financing foreign trade are called "exchange banks."
5. **Central bank:** Central bank is the apex institution which controls, regulates and supervises the monetary and credit system of the country.
6. **Industrial banks:** Bank which provide long-term credit to industries for the purchase of machinery, equipts etc., are known as "industrial banks."
7. **Demand deposits:** Deposits which can be withdrawn by the depositor at any time by means of cheques are known as "demand deposits."
8. **Time deposits:** Deposits which are repayable after the expiry of a specific period are known as "time deposits."
9. **Cash credit:** It is a type of loan which is given to the borrower against his current assets, such as shares, stocks, bonds etc.
10. **Branch banking:** It is banking system under which a big bank as a single institution and under single ownership operates through a network of branches spread all over the country.
11. **Unit banking system:** It is a system under which a single bank operates through a single office.
12. **Chain banking:** Chain banking refers to the system in which two or more banks are brought under common control by a device other than the holding company.
13. **Group banking:** Group banking refers to a system of banking in which two or more banks are directly controlled by a corporation or an association or a business trust.
14. **Mixed banking:** When the commercial banks provide both short-term and long-term finance to commerce and industry, it is called "mixed banking."
15. **Credit creation:** The power of commercial banks to expand deposits through loans, advances and investments is known as "credit creation."

16. **Scheduled banks:** Scheduled banks are those commercial banks which are included in the second schedule of the Reserve Bank of India Act, 1934 and have a paid-up capital and reserves of not less than Rs. 5 lakhs.
17. **Non-scheduled banks:** Non-scheduled banks are trade banks. Their paid-capital and reserves less than Rs. 5 lakhs and are not included in the second schedule of the Reserve Bank of India Act, 1934.
18. **Public sector banks:** These are owned and controlled by the Government.
19. **Private sector banks:** These banks are owned by the private individuals or corporations but not by the Government or co-operative societies.
20. **NABARD:** National Bank for Agriculture and Rural Development is essentially a development bank for promoting agricultural and rural development.
21. **Regional rural banks:** Regional Rural Banks are a new category of banks set up with the objective of increasing the local involvement of banks to meet the credit requirements of weaker sections and small entrepreneurs in the rural areas.
22. **Land Development Bank:** It is a co-operative bank which provides long-term agricultural credit.
23. **Indigenous banker:** An indigenous banker is an individual or private firm receiving deposits and dealing in hundies or lending money.
24. **Money-lender:** The money-lenders are those whose primary business is money lending.
25. **Development banks:** A development bank is a multi-purpose financial institution which is concerned mainly with providing financial assistance to business units.
26. **Money market:** Money market is the market in which short-term funds are borrowed and lent.
27. **Capital market:** Capital market is the market in which medium-term and long-term bonds are borrowed and lent.
28. **Bill market:** Bill market refers to the market for short-term bills generally of three months duration.
29. **Treasury bill:** A treasury bill is a kind of financial bill or promissory note issued by the Government to raise short-term funds.
30. **Commercial paper:** Commercial paper is a short-term negotiable money market instrument.
31. **Discount and Finance House of India:** Discount and Finance House of India is setup in 1988 as the apex body in the Indian market for developing a secondary market for money instruments.
32. **Certificate of Deposit:** It is a money market instrument introduced in India in June 1989, with a view to further widen the range of money market instruments and to give investors flexibility in the development of their short-term funds.
33. **Lead bank:** The Lead bank is the bank which adopts a district and integrate its schemes with district plans for an effective distribution of credit, along with the expanded banking facilities as per the local needs.

34. **State co-operative bank:** It is the apex institution in the three-tier co-operative credit structure, operating at the district level.
35. **Central co-operative bank:** It is in the middle of the three-tier co-operative credit structure, operating at the district level.
36. **Derivative deposits:** Deposits which arise on account of granting loans or purchase of assets by a bank are called “derivative deposits.”
37. **Primary deposits:** Deposits which arise when cash or cheques are deposited by customers in a bank are called “primary deposits.”
38. **Innovative banking:** Innovative banking implies the application of new techniques, new methods and novel schemes in the areas of deposit mobilisation, deployment of credit and bank management.
39. **Merchant banking:** Merchant banking refers to specialisation in financing and promotion of projects, investment management and advisory services.
40. **Deposit mobilisation:** It implies tapping of potential savings and putting them into banking sector for productive uses.
41. **Lien:** A lien is the right of person or a bank to retain the goods or securities in his possession until the debt due to him is settled.
42. **Negative lien:** It is non-possessory lien.
43. **Lunatic:** A lunatic is a person of unsound mind.
44. **Negotiable instrument:** Negotiable instrument means promissory note, bill of exchange or cheque payable either to order or to bearer.
45. **Post-dated cheque:** A cheque which bears a date subsequent to the date of issue is said to be post-dated.
46. **Ante-dated cheque:** A cheque, which bears a date before the date of issue, is said to be ante-dated.
47. **Banker’s cheques:** A banker’s cheque is one which is drawn by a banker upon himself.
48. **Bank draft:** A bank draft is an order to pay money drawn by one office of a bank upon another office of the same bank for a sum of money payable to order or on demand.
49. **Stale cheque:** A cheque is regarded overdue or stale when it has been in circulation for an unreasonable period of time.
50. **Negotiation:** Negotiation is the process by which the ownership of the credit instrument is transferred from one person to another.
51. **Assignment:** Assignment means transfer of ownership in the article by means of a written and stamped document according to the provisions of the transfer of property act.
52. **Endorsement:** Endorsement means “writing of a person’s name on the back of the instrument or on any paper attached to it for the purpose of negotiation.”
53. **Crossing:** The act of drawing two transverse parallel lines on the face of a cheque is called “crossing of the cheque.”

54. **Holder:** A holder means any person entitled in his own name to the possession of the negotiable instrument and to recover or receive the amount due thereon from the parties liable thereto.
55. **Material alteration:** An alteration which alters the business effects of the instruments if used for any business purpose is called "material alteration."
56. **Countermands the payment:** Countermand means "the instruction conveyed by the drawer of a cheque to drawee bank not to pay the cheque, when it is presented for payment."
57. **Conversion:** Conversion is the unlawful taking, using, disposing or destroying of goods, which is inconsistent with the owner's right of possession.
58. **Noting:** Noting is the authentic and official proof presentment and dishonour of a negotiable instrument.
59. **Protest:** Protest is a formal certificate of dishonour issued by the Notary public to the holder of a bill or promote, on his demand.
60. **Escrow:** A negotiable instrument delivered to a person conditionally or for safe custody, but not for the purpose of negotiation, is called "escrow."
61. **Inchoate instrument:** It is an incomplete instrument.
62. **Margin:** Margin means the excess of market value of the security over the advance granted against it.
63. **Documents of title to goods:** Documents, which in the ordinary course of trade, are regarded as proof of the possession or control of goods are called "documents of title to goods."
64. **Stock exchange securities:** Securities which are regularly bought and sold in a stock exchange are called "stock exchange securities."
65. **Consortium advances:** If several banks join together according to their capacities in meeting the credit needs of large borrowers, such advances are known as "consortium advances."
66. **Garnishee order:** Garnishee order is a judicial order served on a bank to suspend its dealings with a customer.
67. **Term loans:** Loans given for long periods are called "term loans."

TRUE OR FALSE STATEMENTS

Note: "T" represents "True" and "F" represents "False"

1. The damage payable in the case of wrongful dishonour of a cheque depends upon the amount of the cheque. (F)
2. Maintenance of secrecy of a customer's account is an absolute obligation. (F)
3. When the funds are deposited for a specific purpose, the banker becomes a trustee. (T)
4. The Law of Limitation runs from the date of the deposit. (F)
5. A banker can exercise his particular lien on the safe custody articles. (T)
6. A negative lien does not give any right of possession to the creditor. (T)
7. The banker has a statutory obligation to honour customers bills. (F)
8. To constitute a person as a customer, there must be a single transaction of any nature. (F)
9. A current account can be opened in the name of a minor. (T)
10. Probate is nothing but an official copy of a will. (T)
11. A guarantee given by an adult in respect of a minor's debt is valid. (F)
12. An account can be opened in the name of a partner on behalf of a firm. (F)
13. The duty of a banker is over as soon as particulars regarding creation of charges are sent to the Registrar within 30 days of their creation. (T)
14. Contracts by lunatics in India are always void. (F)
15. The most undesirable customer is an undischarged bankrupt. (T)
16. Account payee crossing restricts the transferability of a cheque. (F)
17. Any holder of a cheque can cross it. (T)
18. A general crossing cannot be converted into a special crossing. (F)
19. Two parallel transverse lines are not essential for a special crossing. (T)
20. Double crossing, except for the purpose of collection is not valid. (T)
21. The safest form of crossing is general crossing. (F)
22. A cheque which is not crossed is called a bearer cheque. (F)
23. The cancellation of crossing is called opening of crossing. (T)

24. Account payee crossing is a direction of collecting banker. (T)
25. Endorsement is a must for a bearer cheque. (F)
26. A bearer cheque will always be treated as a bearer cheque. (T)
27. In sans frais endorsement, the endorser waives some of his rights. (F)
28. The endorser can be made liable only if he is served with a notice of dishonour. (T)
29. Assignment includes the assumption of liability. (F)
30. Partial endorsement is not valid. (T)
31. There is a statutory obligation on the part of a banker to give reasons while dishonouring a cheque. (F)
32. A Garnishee order can not attach a foreign balance. (T)
33. Any holder can count term and the payment of cheque before it is presented for payment. (F)
34. Payment made outside the banking hours does not amount to payment in due course. (T)
35. Statutory protection as given under Section 85 is not available to a bearer cheque. (F)
36. When the amount stated in words and figures differ, the banker can honour the smaller amount. (F)
37. When a Garnishee order is issued by the court attaching the account of the customer, the banker is called Garnishor. (F)
38. The statutory protection is available to a collecting banker only when he acts a holder for value. (F)
39. It is the duty of a collecting banker to note and protect a foreign bill, in case, it is dishonoured. (T)
40. The banker's rights as a holder for value is similar to that of a holder in due course. (T)
41. The wrongful interference with the goods of another is called "mutilation." (F)
42. If a banker takes a cheque as an independent holder by way of negotiation he cannot get statutory protection. (T)
43. Mortgage of Movables is called pledge. (F)
44. Advances against guarantees are secured loans. (F)
45. The extended of pledge is a case of hypothecations. (T)
46. Business people generally prefer a legal mortgage to an equitable mortgage. (F)
47. No right of sale is available in the case of conditional mortgage. (T)
48. An equitable mortgage can be created in respect of real estate. (T)
49. The most risky charge from a banker's point of view is pledge. (F)
50. Bill of lading is a quasi-negotiable instrument. (T)
51. Banker's receipt is issued in respect of goods deposited with the bank. (F)
52. Goods can be released before the repayment of the loan against trust receipts. (T)

53. Loans can be granted on the face value of a life policy. (F)
54. Garnishee order is issued by the court on the request of the debtor. (F)
55. ATM permits a depositor to withdraw and deposit money any time he likes. (T)
56. While appropriating payments, the money received is to be first applied towards payment of principal and then towards interest. (F)
57. In India the rules regarding appropriation of payments have been given in the Negotiable Instruments Act. (F)
58. In case of a multi-deposit scheme, a deposit may withdraw the money required without breaking his entire deposit. (T)
59. A banker has a right to retain the securities for any number of years till the loan is repaid. (T)
60. A banker's lien is not barred by the Law of Dimitation. (T)
61. A banker is given a special privilege of charging compound interest. (T)
62. Industrial banks help industries by supplying them short-term credit. (F)
63. Land Development Banks grant short-term loans to farmers. (F)
64. Bank creates money. (T)
65. The volume of bank credit depends on the cash reserve ratio the banks have to keep. (T)
66. Unit banking system is most suitable to India. (F)
67. Branch banking system originated in U.S.A. (F)
68. One of the main objectives of nationalisation of banks was to extend credit facilities to the borrowers in the so far neglected sectors of the economy. (T)
69. Narasimham committee strongly recommended the introduction of computerisation in banks. (T)
70. Money market is the market for long-term funds. (F)
71. Capital market deals in capital goods. (F)
72. Investor protection is assigned to stock exchange. (F)
73. Capital Issues Control Act, 1947 has been abolished. (T)
74. SEBI is to protect the interest of investors. (T)
75. SEBI has no role in the working of stock exchanges. (F)
76. SEBI is authorised to control capital market. (T)
77. Capital market helps in improving investment environment. (T)
78. Stock market is the constituent of capital market. (T)
79. Capital market is concerned with the working of financial institutions. (T)
80. Preferential allotment permitted along with right issues. (F)
81. A banking company cannot advance against own shares. (T)

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Fill Up The Blanks

Fill up the blanks with suitable word/words

1. Banking Regulation Act was passed in .... **(1949)**
2. Reserve Bank of India Act was passed in .... **(1934)**
3. Reserve Bank of India was nationalised in .... **(1st January, 1949)**
4. Industrial Finance Corporation of India was established in .... **(1948)**
5. Industrial Development Bank of India was setup in .... **(July, 1964)**
6. Industrial Credit and Investment Corporation of India was established in .... **(1955)**
7. Export and Import Bank of India was set up in .... **(1982)**
8. Exchange banks specialise in financing .... **(Foreign trade)**
9. Current deposits are also called .... **(Demand deposits)**
10. Loans which can be called back by the bank at a very short notice of one day to fourteen days are called .... **(Money at call)**
11. The maturity period of term loans is more than .... **(One year)**
12. Banks are called public conservators of .... **(Commercial virtues)**
13. Unit banking system originated and grew in .... **(U.S.A.)**
14. Banking system which is very popular and successful in India is .... **(Branch banking system)**
15. 14 major commercial banks were nationalised in .... **(July, 1969)**
16. A nine member committee on the financial reforms under the Chairmanship of Narasimham submitted its report on .... **(December 1991)**
17. Lead Bank Scheme was introduced by the Reserve Bank towards the end of .... **(1969)**
18. NABARD was set up on .... **(12th July, 1982)**
19. Regional Rural Bank Act was passed in .... **(1976)**
20. At present there are .... regional rural banks in India. **(196)**
21. The Small Industries Development Bank of India was set up by the Government of India in .... **(April, 1990)**

22. The market which deals in trade bills, promissory notes and government papers or bills, which are drawn for short-periods is called .... **(Money market)**
23. A financial market in which short-term papers or bills are brought and sold is known as .... **(Bill market)**
24. In order to protect the interests of investors and regulate the working of stock exchanges, the Government in 1988 set up the .... **(Stock Exchange Board of India)**
25. The financial market for long-term funds is known as .... **(Capital market)**
26. A banker is a .... debtor. **(Privileged)**
27. A banker's lien is always .... lien. **(General)**
28. To claim a banking debt ....in writing is necessary. **(An express demand)**
29. .... is necessary to exercise a lien **(No agreement)**
30. The word customer signifies a relationship in which .... is of no essence. **(Duration)**
31. For wilful dishonour of a cheque .... damage is payable by the banker. **(Vindictive)**
32. Accepting a bill and making it payable at the bank is called .... **(Domiciliation of a B/E)**
33. Honouring of a cheque is a .... obligation. **(Statutory)**
34. The relationship between the banker and customer is primarily that of a .... **(Debtor and creditor)**
35. The minimum period for which a fixed deposit can be accepted is .... **(45 days)**
36. Money can be withdrawn any number of times in .... **(Current A/C)**
37. ....must be obtained from a responsible person before opening an account. **(A letter of introduction)**
38. If there are no withdrawals for a period of 12 months in a savings bank account, the account is said to be .... **(Dormant)**

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