Unit 3

Banking Operations

Introduction

Collecting banker is one, who undertakes the collection of cheques for his customer. Now-a-days banks undertake to collect even other instruments like bank drafts, bills of exchange, dividend warrants etc.,

Role of a Collecting Banker

1. Collection of Cheques from his customers.
2. Segregating them into (a) Local Cheques and (b) Outstation Cheques.
   a) In case of Local Cheques: The banker presents the cheque to the paying banker/drawee and if cheque is honoured, he credits the customer's account with the amount realised.
   b) In case of Outstation Cheques: The banker will send the cheque for clearance to the concerned bank through post and if cheque is honoured, the account of the customer will be credited with the realised money.
3. If the cheque is dishonoured – the same will be informed to the customer and the cheque will be returend with a remark- R. D {refer to the drawer}.

General duties of a Collecting Banker

1. Collecting Banker should undertake the collection of cheques, drafts, bills etc., only for his customer.
2. Before opening an account in the name of a new customer, he should insist on satisfactory introduction or reference testifying the integrity and honesty of the customer.
3. Before accepting a cheque for collection on behalf of a customer, he should examine the validity of the title of the customer to the cheque.
4. Before accepting a cheque for collection, he should examine the correctness of all endorsements of the cheque.
5. If uncrossed cheques are deposited for collection, the collecting banker should first get them crossed by the customer and then accept them for collection. The banker should never take the responsibility of crossing the cheque, after accepting it for collection.

Collecting banker as a Holder for Value

Collecting Banker becomes the holder for value, if he pays the value of the cheque to the customer before the cheque is actually collected. In this, the collecting banker initially pays the amount to the customer, and then presents the cheque for collection to the Drawee/Paying banker as though, he himself is a customer.

In the following cases the Collecting Banker becomes a Holder for value:

a) When Collecting Banker pays the value of a cheque to the customer, before it is collected/realised
b) When Collecting Banker acquires a cheque from the customer in exchange for cash.
c) When Collecting Banker allows a customer to withdraw the money against the cheque deposited – before it is realised
d) When a banker accepts a cheque from the customer, to appropriate the proceeds towards the loan of the customer or when the banker exercises his Lien on the proceeds of the cheque.
e) When Collecting Banker advances money against the cheque meant for collection.

Rights as a holder for value:

1. The proceeds of the collection will be retained by the banker.
2. In case the cheque is dishonored, the Collecting Banker may recover the money paid, from all or any endorser of the cheque.
3. If the cheque collected had forged endorsement – the Collecting Banker has right to recover the amount from all the concerning endorsers, subsequent to forgery.

Liabilities as a Collecting Banker

If a cheque has forged endorsement or defective title and if the Collecting Banker collects the cheque for himself, he is liable to the real owner or to the legal owner of the cheque.

Collecting Banker As An Agent Of His Customer

In this case the Collecting Banker acts only as an agent of his customer, i.e., he collects the cheque from the customer, sends it to the clearinghouse and credits the account with the amount realised.

Rights of Collecting Banker as an agent of his customer

When a collecting banker collects a cheque as an agent of his customer, he has not rights of his own. His rights or title to the cheque will be the same as that of the customer.

Liabilities:

1. The Collecting Banker should execute the collection work honestly and without any negligence. If any loss is caused due to negligence, such loss has to be reimbursed by the Collecting Banker
2. In case of forged endorsement/ statutory direction the realised amount shouldn't be given to the customer. If he pays, the Collecting Banker will be held liable.

Precautions to the taken by the Collecting Banker while acting as a Holder for a Value

1. The Collecting Banker has to obtain a consent letter from the customer. It is advisable for the banker to take an undertaking from the customer, whose cheque has been received for a value, that the customer will reimburse the banker, in case the cheque is dishonoured.
2. Collecting Banker must present the cheque for payment within reasonable time.
3. In case of dishonour, within the reasonable time notice has to be given to all the concerned endorsers.

Statutory Protection To The Collecting Banker

The Negotiable Instruments act of 1881, provides some protection to the collecting banker as he cann't examine each and every cheque in detail presented for collection. Sections 131 and 131 A of the act deals with the protection given to the collecting banker.

Section 131 gives protection to the collecting banker in respect of a cheque bearing a forged endorsement or in respect of a cheque to which the customer has no title or has a defective title. This section states that "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 a cheque by reason only of having received such payment"

The Collecting Banker may claim for protection under section 131, only if the following conditions are satisfied:

1. This protection is available only for a "Crossed Cheque".
2. The protection can be claimed only if the cheque is crossed before it reaches the collecting banker. If the collecting banker receives open cheque and if he himself crosses it and sends for the payment - collecting banker can't get the protection.
3. The Collecting banker can claim this protection, only when he has collected the cheque as an agent for his customer. If he is a holder for value – he can't get the protection.
4. This protection can be claimed only if the collecting banker has collected the cheque in good faith and without negligence.

Section 131 A of the Negotiable Instruments act of 1881, protects the interests of the collecting banker against the collection of a 'bank draft' having forged endorsement or defective title. But in order to get the protection under law all the above stated conditions must be fulfilled.

Banker acting as both Collecting and Paying Banker

Sometimes, the cheques are drawn on the same banker by one customer for another customer. In this case, the banker will be acting as both paying banker and collecting banker. He will be given protection under both the capacities, if he satisfies the conditions relating to both the provisions given for protection.

Paying Banker

Meaning

The bank on which a cheque is drawn (the bank whose name is printed on the cheque) and which pays the amount for which the cheque is written and deducts that sum from the customer's account.

Precautions of a Paying Banker

Presentation of Cheque

First of all a paying banker should note whether the presentation of the cheque is correct. It can be found out by noting the following factors.

a) Type of Cheque: Cheques may generally be of two types – open or crossed. If it is open one, the payment may be paid at the counter. If it is crossed, the payment must be made only to a fellow banker.
b) Branch: The paying banker should see whether the cheque is drawn on the branch where the account is kept.
c) Banking Hours: The paying banker should also note whether the cheque is presented during the banking hours on a business day.
d) Mutilation: If the cheque is from into pieces or cancelled or mutilated, then the paying banker should not honour it.

Honoring a Cheque

a. Printed Form: The customer should draw cheques only on the printed leaves supplied by the bankers failing which the banker may refuse to honour it.
b. Unconditional Order: The cheque should not contain any condition
c. Date: Before honoring a cheque, the paying banker must see whether there is a date on the instrument. if a cheque is ante dated, it may be paid if it has not exceeded six months from the date of its issue otherwise it will become stale one. If a cheque is post dated, he should honor it only on its due date.
d. Amount: The paying banker should see whether the amount stated in the cheque both in words and figures agree with each other.
e. Material Alteration: If there is any material alteration the banker should return it with a memorandum “Alteration requires drawer’s confirmation”.
f. Sufficient Balance: If the funds available are not sufficient to honour a cheque, the paying banker is justified in returning it.
g. Signature of the Drawer: It is the duty of the paying banker to compare the signature of his customer found on the cheque with that of his specimen signature.

h. Endorsement: The banker must verify the regularity of endorsement, if any, that appears on the instrument.
i. Legal Bar: The existence of legal bar like Garnishee order limits the duty of the banker to pay a cheque.

Statutory Protection to the Paying Banker

Protection in case of order cheque

In case of an order cheque, Section -85(1) provides statutory protection to the paying banker as follows : "Where 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". However, two conditions must be fulfilled to avail of such protection.

(a) Endorsement must be regular : To avail of the statutory protection, the banker must confirm that the endorsement is regular.

(b) Payment must be made in Due Course : The paying banker must make payment in due course. If not, the paying banker will be deprived of statutory protection.

Protection in case of Bearer Cheque

This section implies that a cheque originally issued as a bearer cheque remains always bearer. In other words it retains its bearer character irrespective of whether it bears endorsement in full or in blank or whether any endorsement restricts further negotiation or not. So the banks are not required to verify the regularity of the endorsement on bearer cheque, even if the instruments bears endorsement in full. The banker shall free from any liability (discharged) if he makes payment of an uncrossed bearer cheque to the bearer in due course. If such cheque is a stolen one and the banker makes its payment without the knowledge of such theft, he will be discharged of his obligation and will be protected under Section -85(2).

Protection in case of Crossed cheque

The paying banker has to make payment of the crossed cheques as per the instruction of the drawer reflected through the crossing. If it is done, he is protected by Section -128. This section states "Where the banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque and (in case such cheque has come to the hands of the payee) the drawer thereof shall respectively be entitled to the same rights, and be placed in if the amount of the cheque had been paid to and received by the true owner thereof".

Thus, the paying banker is free from any liability on a crossed cheque even if the payment was received by the collecting banker on behalf of a person who was not a true owner. For example, a cheque in favour of X is stolen by Y. He endorses it in his own favor by forging the signature of X and deposits it in his bank for collection . In this case, the paying banker shall be discharged if he makes payment as mentioned above and shall not be liable to pay the same to X, the true owner of the cheque.

The drawer of the cheque is also discharged since protection is also granted to him under this Section. There is, however, one limitation to the protection granted under this Section. If the banker cannot avail of the protection granted by other Section of the Act, the protection under Section -128 shall not be available to him.

Dishonor of Cheques

Section 92 of the Negotiable Instruments Act states that –

"A promissory note, bill of exchange or cheque is said to be dishonored by non-payment when the maker of the note and acceptor of the bill makes default in payment."

Grounds of Dishonor

1. Funds Insufficient: The amount of money standing to the credit of the account of the drawer on which the cheque is drawn is insufficient to honour the cheque, or the cheque amount exceeds the amount that can be paid by the bank under an arrangement entered into between the bank and the drawer of the cheque.
2. Account Closed: It is an offence under section 138 of the Act – Closure of account would be an eventuality after the entire amount in the account is withdrawn. It means that there was no amount in the credit of 'that account' on the relevant date when the cheque was presented for honouring the same.
3. Stop Payment instructions: Once the cheque has been drawn and issued to the payee and the payee has presented the cheque, 'stop payment' instructions will amount to dishonour of cheque.
4. Refer to drawer: "Makes out a case under section 138 of the Negotiable Instruments Act, 1881 which expression means that there were not sufficient funds with the bank in the account of the respondent"
5. Not a clearing member: Cheque returned with endorsement 'not a clearing member'. To attract the provisions of section 138 NI Act, the cheque should be presented with the bank on which it I drawn- If the cheque is not presented to the bank on which it is drawn, then provisions of sec 138 would not be attracted. If bank on which the cheque is drawn is not a clearing member of the Reserve Bank of India – unpaid return of the cheque would not attract section 138.
6. Effect of other endorsements: It has been repeatedly held by courts that manifest dishonest intention of the drawer resulting in dishonour of the cheque would lead to prosecution under section 138 Negotiable Instruments Act regardless of the actual ground of dishonour.

Consequences Of Wrongful Dishonor Of Cheques

A banker has the statutory obligation to honour his customer's cheques unless there are valid reasons for refusing payments of the same. In case be dishonours a cheque, intentionally or by mistake, he is liable to compensate the customer for the loss suffered by him. According to Section 31 of the Negotiable Instruments Act, 1881, the banker is liable to compensate the drawer for any loss or damage

caused by the default on his part in dishonouring the cheques without sufficient reason. The banker thus incurs heavy liability for any mistake or default committed in dishonouring his customers' cheques.

Lending Operations of Banks

Principles of Lending

1. Liquidity: Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice. A bank chooses such securities in its investment portfolio which possess sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirements of its customers, it should be in a position to sell some of the securities at a very short notice without disturbing their market prices much. There are certain securities such as central, state and local government bonds which are easily saleable without affecting their market prices. The shares and debentures of large industrial concerns also fall in this category. But the shares and debentures of ordinary firms are not easily marketable without bringing down their market prices. So the banks should make investments in government securities and shares and debentures of reputed industrial houses.
2. Safety: The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing. Like other investments, bank investments involve risk. But the degree of risk varies with the type of security. Securities of the central government are safer than those of the state governments and local bodies. And the securities of state government and local bodies are safer than those of the industrial concerns. This is because the resources of the central government are much higher than the state and local governments and of the latter higher than the industrial concerns. In fact, the share and debentures of industrial concerns are tied to their earnings which may fluctuate with the business activity in the country. The bank should also take into consideration the debt repaying ability of the governments while investing in their securities. Political stability and peace and security are the prerequisites for this.
3. Diversity: In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimising risk of the investment portfolio of a bank. The principle of diversity also applies to the advancing of loans to varied types of firms, industries, businesses and trades. A bank should follow the maxim: "Do not keep all eggs in one basket." It should spread it risks by giving loans to various trades and industries in different parts of the country.

4. Stability: Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest it funds in the shares of reputed companies where the possibility of decline in their prices is remote.
5. Profitability: This is the cardinal principle for making investment by a bank. It must earn sufficient profits. It should, therefore, invest in such securities which was sure a fair and stable return on the funds invested. The earning capacity of securities and shares depends upon the interest rate and the dividend rate and the tax benefits they carry. It is largely the government securities of the centre, state and local bodies that largely carry the exemption of their interest from taxes. The bank should invest more in such securities rather than in the shares of new companies which also carry tax exemption. This is because shares of new companies are not safe investments.

Kinds of Lending Facilities

1. Overdraft: These types of advances are given to current account holders. No separate account is maintained. All entries are made in the current account. A certain amount is sanctioned as overdrafts which can be withdrawn within a certain period of time say three months or so. Interest is charged on actual amount withdrawn. An overdraft facility is granted against a collateral security. It is sanctioned to businessman and firms.
2. Cash Credits: The client is allowed cash credit upto a specific limit fixed in advance. It can be given to current account holders as well as to others who do not have an account with bank. Separate cash credit account is maintained. Interest is charged on the amount withdrawn in excess of limit. The cash credit is given against the security of tangible assets and / or guarantees. The advance is given for a longer period and a larger amount of loan is sanctioned than that of overdraft.
3. Loans: It is normally for short term say a period of one year or medium term say a period of five years. Now-a-days, banks do lend money for long term. Repayment of money can be in the form of installments spread over a period of time or in a lumpsum amount. Interest is charged on the actual amount sanctioned, whether withdrawn or not. The rate of interest may be slightly lower than what is charged on overdrafts and cash credits. Loans are normally secured against tangible assets of the company.
4. Discounting of Bill of Exchange: The bank can advance money by discounting or by purchasing bills of exchange both domestic and foreign bills. The bank pays the bill amount to the drawer or the beneficiary of the bill by deducting usual discount charges. On maturity, the bill is presented to the drawee or acceptor of the bill and the amount is collected.
5. Letters of Credit: A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase

NPA

Meaning

An account is declared as NPA based on the recovery of installments and interest on loans and advances and other aspects as per RBI norms.

Circumstances and Impact

Recovery of Non Performing Assets (NPAs) is one of the biggest problems for the Indian banking industry. Money borrowed by business persons and industrial houses are not repaid promptly. Further interest payments due on the loans are also not paid on time.

A loan becomes an NPA, when the borrower fails to repay the loan or interest payment within six months from the due date for such payments.

Thus, after 180 days from the due date of loan repayment/interest payment, loans are classified by banks/financial institutions as NPAs. (The period of delay in payment of interest or principal amount for 180 days for classifying a loan asset as NPA has been cut down to 90 days from April 2003 by the Reserve Bank of India).

In many such cases, the default is deliberate and willful; default arises even when a borrower has sufficient funds to pay the interest and principal amount but does not pay it to the bank.

Banks and financial institutions in India (financial institutions, generally, lend money for long term like, project related purposes while, banks usually lend money for short term like, working capital needs) are reportedly carrying about Rs. 75,000/- crore of NPAs in their books as at the beginning of 2002.

Of this, nearly Rs. 60,000/- crore is accounted for by public sector banks. Hence, the new Securitization Act will primarily help public sector banks to reduce the level of NPAs through recovery and avoidance of fresh NPAs.

Banks and financial institutions usually lend money against securities. Therefore, if banks are given powers to seize and sell the assets furnished as security for loans, banks may be in a position to reduce the level of NPAs with them.

For this purpose, Parliament has recently enacted an Act known as "Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002". The Act is briefly known as Securitization Act. In a simple sense, it may be referred to NPA Recovery Act. The provisions of this Act are applicable both for banks and financial institutions as lenders of funds.

The Securitization Act is essentially about reducing NPAs in financial institutions and banks. The non performing assets (they are also called 'bad loans') create three main diffi-culties for the banks.

One, the banks are required to make provisions against NPAs. As provisioning is done by debit to P & L A/c, this leads to reduced profit for that year.

Second, bad loans do not generate interest's income for the banks. As such interest incomes of the banks fall.

Third, fall in interest income reduces the capacity of banks to make fresh loans and the problem of mismatch in assets-liabilities of banks.

Under the provisions of the new Act, lenders (banks and financial institutions) can seize the assets offered as security for loans by borrowers and sell them for manages them for recovery of dues from borrowers. The lenders can do this without the intervention of courts. The lending institutions are how-ever, required to give a 60 days' notice to the borrowers before enforcing their right of sei-zure and sale of assets.

The Act basically deals with three types of actions by banks and financial institutions in respect of financial assets held by them. These are (1) Securitization of Assets, (2) Setting up of Asset Reconstruction Companies, and (3) Enforcement of Securities for recovery of loans.

Securitization of Asset refers to bundling of various loan assets held by banks into a single type of asset like bonds and sell the bonds in the market for raising fresh funds. Thus, the banks can unlock or create fresh funds out of existing loans instead of waiting for repay-ments of such loans on maturity dates.

In case of Asset Reconstruction Companies (ARC), banks and financial institutions can sell poor quality loan assets to the ARC and get them relieved of such bad quality assets from their balance sheet. Thus, banks will realize immediate sale proceeds and the poor quality or worthless assets are removed from their balance sheet and transferred to ARC.

The Enforcement of Securities functions refers to seize and sell assets offered as collat-eral securities for loans, making loan recovery very easy. The new Act referred to above enables banks and financial institutions to recover loans from defaulting borrowers in a easier way without the hassle and involvement of courts.

The Act will put a hammer on the head of willful defaulters who, despite the fact of having capacity to repay the loan, avoid paying the dues to banks. Earlier the borrowers deliberately avoid payments knowing full well that court cases for recovery of loans takes a lot of time, cost and uncertainty of court verdict.

The tricky borrowers many a time dis-poses of the assets without the knowledge of lenders during the pendency of court cases. The new act makes all such tricks of borrowers as a thing of the past.

Banks have since started taking advantage of the new Act and seized possession of borrowers' as a thing of the past. Banks have since started taking advantage of the new Act and seized possession of borrowers' assets in many cases.

Many banks have already started exercising their power under the Act for recovery of bad loans. It is good to note that banks are able to recover sizeable amount of bad loans from defaulting borrowers during the year 2002-03.

Priority Lending in Banks

The concept of priority sector was evolved in the late sixties in order to focus attention on the need to ensure adequate credit facilities to certain neglected sectors of the economy particularly in the rural areas where banks had hardly made their presence felt.

The in-volvement of banks in priority sector lending has grown considerably since then along with the extension of the branch network of banks into the rural areas with special empha-sis on opening branches in unbanked areas.

With a view to ensuring flow of credit to the neglected sectors like agriculture and small scale industries, the concept of priority sector lending was evolved and commercial banks were advised to grant at least 40% of their total advances to borrowers in the priority sectors, comprising agriculture, small scale industries, small road and water transport op-erators, retail trade, small business, professional and self-employed persons, education, and for housing purposes within certain limit.

The banks advance to the priority sector which stood at 14% of their total advances in June 1969 increased to 46% as at the end of December 1988, though this percentage is marginally falling since then.

In March 1997, scheduled commercial banks', advances to priority sector stood at Rs. 93,807 crore consti-tuting 35 per cent of total credit of commercial banks.

One will be surprised to know that even the most developed nation in the world viz. USA has enacted a law called 'Commu-nity Reinvestment Act, (CRA) under which banks are required to invest/utilize a certain amount of their deposits in poor areas.

As of now the Indian Rural Credit Delivery System comprise about 33,000 branches of commercial banks and RRBs and over 92,000 outlets of credit co-operatives at the base level.

Broadly, the categories of bank advances included under priority sector are: (a) Agriculture (b) SSI (c) Small road and water transport operators, retail traders, small business operators, professionals and self employed persons, SHG, NGOs, (self help groups and Non- Government organizations) state sponsored SC\ST organizations, education, hous-ing and consumption loans for weaker sections.

In case of foreign banks operating in India, their advances to Export Sector are treated as priority sector advances. This criterion is not applicable to public sector banks. Since foreign banks are not allowed to open branches in rural/semi-urban areas, they are not in a position to lend to rural sector. Hence, this relaxation.

Over time the definition of priority sector advances has been widened to cover commercial banks' investment in special bonds issued by certain financial institutions like National Hous-ing Bank for exclusive financing of priority sector.

The achievement of the set goals under priority sector lending has been pursued vigorously with banks by RBI. As a result of these efforts the public sector banks increased their advances to the priority sector Currently priority sector advances by commercial banks have crossed Rs.1,00,000 crore.

The efforts of public sector banks in rural development through priority sector loans are notable and admirable. It is one of the great achievements of Indian Banking system and nationalization of banks.

Newly set-up private sector banks have been permitted to substitute the agricultural lending, by contributions to deposits with NABARD \ SIDBI for a period of 3 years from the date of inception.

Available for units with investment in plant and machinery up to Rs. 5 lakh, 20% for units with investment between Rs. 5 lakh and Rs. 25 lakh and the remaining 40% for other SSI units