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## UNIT 13 BANKING

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### 13.0 OBJECTIVES

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After studying this unit, you should be able to:

- explain the meaning of a bank
- describe the types of banks
- explain the relationship between banker and customer
- list the duties and rights of banks
- describe the types of accounts and their operations
- enumerate the methods of making payments through banks
- explain the methods of advance and loans
- describe the role of credit cards.

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### 13.1 INTRODUCTION

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You have already studied that all those activities which facilitate the trade are called 'aids to trade' or 'auxiliaries to trade'. Aids to trade eliminate the hindrances and facilitate the flow of goods from producer to consumers. They are classified into five categories: (1) advertising, (2) banking, (3) insurance, (4) transportation, and (5) warehousing. You have already studied about advertising in Block 3. You will study the remaining four aids to trade in this block.

This unit is devoted for banking. In this unit, you will learn the meaning and classification of banks, the different types of accounts that can be opened in a bank and their operations, various types of bank and various methods of payments through banks. You will also learn about electronic banking and credit cards.

## 13.2 WHAT IS A BANK

In simple words, bank is an institution which deals in money. Banks accept surplus money from those who are not needing it immediately and lend it to those who need it. Let us see the various definitions of bank given by different authors and understand the main features of a bank.

"A banker is one who in the ordinary course of his business honours cheques drawn upon him by persons from and for whom he receives money on current accounts"

- Herbert L. Hart

"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".

- H. P. Seldon

"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 Regulation Act [Sec.5(1)(p)]

"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".

- Sir John Paget

If you go through the above definitions of a bank, you will notice that a bank must perform two essential functions: 1) acceptance of deposits from public, and (2) lending or investing the same. It is also provided that the bank is under the obligation of repaying money on demand to respective depositors. You should note that the banker does not refund the money on his own accord, even if the period for which it was deposited expires. Thus, the depositor must make a proper demand for refund of money.

Acceptance of deposits of money is an essential function no doubt, but simply because a company is accepting deposits of money from the public, does not make it a banker. It is necessary that the deposits accepted should be used for lending or investment. The banks mobilise the resources by accepting deposits and utilise such funds by employing them profitably. The banker is, thus, an intermediary and deals with the money belonging to the public.

In the modern days, industrial units and commercial undertakings also accept deposits of money from the public with the facility to withdraw them when required or after the expiry of a certain agreed period. But such institutions cannot be termed as bankers because acceptance of deposits is their subsidiary business, while the main function is manufacturing or trading.

Besides receiving deposits and lending or investing funds, the banks also perform various subsidiary services such as collection of cheques, drafts and bills, collection of interests and dividends on securities, making payment on behalf of his customers, remittance of funds, discounting the bills of exchange, acceptance of valuables for safe custody, etc.

From the above discussion, you identify the distinguishing features of a bank as follows:

- Acceptance of deposits of money from the public
- Profitable employment of such funds
- Obligation to refund deposits on demand
- Lending or investing money
- Banking as the main business.

Thus, if a concern carries on banking business only as an ancillary to some other main business, it cannot be considered as a bank.

## 13.3 TYPES OF BANKS

There are different institutions who conduct their operations in a different manner. On the basis of their functions, we can classify banks as follows:

Commercial Banks: Commercial banks are the oldest institutions having a wide network of branches throughout the country. A commercial bank is a monetary institution which serves the interest of its depositors by utilising their funds in profitable ventures and provide a variety of services to its customers. Commercial banks may either be owned by the Government or may be run in the private sector. Besides deposit mobilisation, the commercial banks provide not only short-term loans but also medium and long term loan to trade and industry.

2. Co-operative Banks: Cooperative banks are private sector banks. A cooperative bank is a voluntary association of members for self help and caters to their financial needs on a mutual basis. These banks are also subject to control and inspection by the Reserve Bank of India. Such banks get their resources from their shares, public deposits and also loans from the state cooperative banks. They also get short and medium term loans from the Reserve Bank of India. To enhance public confidence in cooperative banks, the Reserve Bank of India has extended the Credit Guarantee Scheme to cooperative banks.
3. Land Development Banks: These banks provide long term credit to agriculture for purposes such as pump sets, tractors, digging up wells, land improvement, etc. These banks raise their resources mainly by flotation of debentures, subscribed by the State Bank Group, commercial banks, LIC and by RBI. These banks grant loans to farmers against the security of their land. The land development banks cannot be strictly called banking institutions because they are not required to mobilise deposits and not to maintain cash reserve ratio.
4. Regional Rural Banks: The main objective for setting up of the RRB's was to provide credit and other facilities, especially to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in rural areas. The RRB's are sponsored by scheduled banks, usually a nationalised commercial bank.
5. Industrial Banks: These banks have come up to promote rapid industrial development. Such banks provide medium and long term loans to industrial sector. They also do underwriting of public issues by corporate sector and guarantee. They render other services like identification of suitable projects, preparation of project reports, providing technical advice and managerial services, raising standards of management, etc. We have a number of such banks in India, namely, Industrial Development Bank of India (IDB), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India Ltd. (ICICI), Industrial Reconstruction Bank of India (IRBI), etc.
6. Central Bank: Every country has a Central Bank of its own. It is called a Central Bank because it occupies a central position in the monetary and banking system of the country and is the highest financial authority. It is the apex bank and the statutory institution in the money market of a country. In India, Reserve Bank of India is the central bank. The main function of this bank is to regulate and supervise the whole banking system in the country. It is a banker's bank and controller of credit in the country. It has the sole right of note issue. It is a lender of last resort and custodian of foreign exchange of the country.

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## 13.4 ROLE OF COMMERCIAL BANKS

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Commercial banks play a very important role in the economic development of the country. Banks are the nerve centre of trade, commerce and business in any country. We can discuss the role of commercial banks by examining the services provided by them as under:

1. Collection of Deposits: Accepting deposits from the customers is one of the main function of the banks. By mobilising deposits the commercial banks help in the development of savings habit in the public. Bank deposits are not only safe but bank also earn interest on it.
2. Facilitate Payments: Banks facilitate Payments through cheques which is a very convenient and safe mode of making payments. Cheques serve as a ready proof of the fact that the payment has been made. When payments are made by cheques, there is no need of carrying large amounts of cash and the trouble of counting is avoided.

3. **Provide Loans and Advances:** Commercial banks grant loans and credit facilities to the public. Banks also allow overdraft facilities to its customers, thus providing them instant credit. Banks issue letters of credit, thus enabling businessmen to deal with strangers because payment is guaranteed.
4. **Provide Credit Information:** Commercial banks provide vital information relating to the credit worthiness of their customers. Whenever a businessman deals with another businessman for the first time, he would like to know the financial position of the other person. In such case if he refers it to his banker, who provides the necessary information.
5. **Discounting of Bills:** The banks lend money by discounting bills. Discounting a bill of exchange means the advancing of a loan against a promise to pay in future. This is a very popular method of lending as the loans are self liquidating.
6. **Collection of Cheques, etc.:** Banks also undertake to collect the amount of cheques, drafts, bills of exchange etc. on behalf of its customers.
7. **Safety of Valuables:** The banks provide safe deposit vaults (lockers) wherein valuables such as jewellery, ornaments, documents, etc., can be kept safely.
8. **Remittance of Money:** If money is to be remitted to any other place, it can be done quickly through banks. Now some of the banks provide 24 hours service, wherein by giving your personal identity number, you can withdraw money at any hour of the day.

From the above you must have noted that the commercial banks play a very important role in the business world. We cannot think of a modern society without banks. The banks are playing a pioneering role in lending, particularly to the priority sector, constituting agriculture, small scale industries and small business. The emerging environment offer ample opportunities to banks to venture into new and profitable areas.

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## 13.5 BANKER AND CUSTOMER

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You have learnt the meaning and functions of a bank. Now let us discuss the meaning of a customer of a bank.

### 13.5.1 Who is a Customer ?

Ordinarily, the customer of a bank means a person who has an account with a bank. According to Sir John Paget, "To constitute a customer there must be some **recognisable** course or habit of dealing in the nature of regular banking business. It is difficult to reconcile the idea of a single transaction with that of a customer". According to this view, to constitute a customer of a bank it is necessary to satisfy two conditions, (i) there must be regular transactions or that the customer must have the habit of dealing with the bank, and (ii) the transaction between them must be of a banking nature.

The first condition means that a single banking transaction will not make a person a customer of a bank. He must maintain his account with the bank for a reasonable duration, and must deal with the bank quite frequently. But now this view has been discarded. In *Ladbroke vs. Todd*, it was held, "the relationship of banker and customer begins as soon as the first cheque is paid in and accepted for collection". According to this decision, a person becomes a customer of a bank as soon as the bank account is opened. In the case of *Commissioners of Taxation vs. English, Scottish and Australian Bank*, it was held, "duration is not the essence to signify the relationship between a banker and customer." In a recent case of *The Central Bank of India vs. Gopinathan Nair & Others* the Kerala High Court observed, "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 by the banker on the footing that the banker will honour drawings upto the amount standing to his credit, **irrespective** of his connection being of short or long standing." From the above, it should be clear to you that as soon as an account is opened in a bank and the first transaction takes place, the person becomes a **customer** of that bank. You should remember that casual transactions carried on through a bank, without having a bank account, will not make a person a customer of the bank, even if they are carried on for a long duration.

### 13.5.2 Relationship between Banker and Customer

You have learnt what is a bank and who is a customer. Now let us understand the relationship between the two. The relationship between a banker and a customer is as follows:

1. **Contractual Relationship:** The primary relationship between a banker and a customer arises from a contract between the two, so it is a contractual relationship. The contract takes place the moment an account is opened by a customer with a bank and this contract remains valid till the customer operates his account as per the terms and conditions agreed between them.
2. **Debtor and Creditor Relationship:** The relation of a banker and customer is primarily that of a debtor and creditor. When a customer opens an account with a bank and maintains a credit balance, the banker assumes the position of a debtor and the customer assumes the role of a creditor. Money deposited with the bank becomes a debt due from him to the customer. The banker can use the money deposited with him by the customers in any manner according to his discretion, his only obligation being to repay the debt as and when demanded by the customer.
3. **Bailee and Bailor Relationship:** When a bank accepts deposits of money, he does not act as a bailee. This is so because a bailee accepts the bailment of goods on the condition that the things bailed will not be utilised by him and the identical goods will be returned. But a bank does not accept money from customer on the condition that it will not utilise the money and that the identical money (the same currency notes or coins deposited by customer) will be returned.

A banker provides for safe deposit vaults and accepts documents and valuables for safe custody. Here the bank is acting as a bailee and the relationship is that of bailee and bailor.

4. **Trustee Beneficiary Relationship:** Banks also act as trustees and executors of will of customers. A trustee is required to hold property and money and use the trust money in accordance with the trust deed and use it for the benefit of some other person known as beneficiary. A customer may deposit some money with the bank for a specific purpose with specific instructions to the bank regarding its use. In such cases, the banker is the trustee of the customer's money, and the banker cannot employ them for any other purpose other than the purpose specified by the customer. You should note here that the money held under trust is different from the money received as deposits.

The legal position of a banker as a trustee is different from that of a debtor to the customer. The relationship is determined by the particular circumstances in each case. For instance, when a bank receives a cheque from the customer for collection from another bank, the bank becomes a trustee till the amount of cheque is realised. Once the amount is credited to the customer's account, the banker assumes the position of a debtor.

5. **Principal-Agent Relationship:** Banks perform many agency functions such as collection of cheques or drafts or bills, collection of interest and dividends on securities, arranging for remittances and payment of insurance premiums, etc., as per the instructions of the customers. In all such cases, the bank is acting as an agent of the customer. In these cases the position of a customer is that of the principal and the position of the banker is that of the agent. Here the bank has to act according to the instructions of the customer.

### 13.5.3 Duties of a Bank

The relationship between the banker and customer creates some obligations on the part of a bank. The main obligations of the banker towards the customer are as follows:

1. **Obligation to Honour Cheques:** You know that a bank is the debtor of his customer. The bank has a statutory obligation to honour the cheques of its customers upto the amount standing to the credit of the customer's account. If a bank wrongfully refuses to honour the cheque of its customer, the bank shall be liable to compensate the customer. This obligation is subject to some conditions, namely:

- a) There must be sufficient funds of the customer in the hands of the bank.
  - b) The funds must be properly applicable for the payment of the customer's cheque.
  - c) The cheque must be properly drawn up i.e., it should be complete in all respects.
  - d) The cheque must be presented for payment within a reasonable time.
  - e) There must be no legal bar preventing the payment of such cheques. If the bank has received any order from a court or any other competent authority prohibiting payment, it is the duty of the bank to obey such orders.
2. **Obligation to Maintain Secrecy:** The relationship between the banker and customer is of a confidential nature. The bank must not disclose to any outsider the details concerning the customer's account, as such disclosures may adversely affect the credit and business of the customer. However, a disclosure can be made under the following two situations :  
(a) when the law requires such disclosures to be made, and (b) when the practices amongst the banks permit such disclosure.
  3. **Obligation to Follow Customer's Instructions:** The banker is under a legal obligation to follow the instructions of the customer. This is so because there is the contractual relationship between the bank and the customer.
  4. **Obligation to Maintain Proper Records:** The banker is under an obligation to maintain accurate record of all the transactions of the customers made with the bank.
  5. **Obligation to give Notice before Closing the Account:** If a bank wishes to close the account of a customer, it must give a reasonable notice to this effect to the customer. Thus, a bank cannot close the account of a customer on its own, because it may have serious consequences to the customer.

### 13.5.4 Rights of a Bank

For fulfilling the obligations towards the customers, bankers enjoy the following rights:

- I. **Right of General Lien:** One of the most important rights enjoyed by a bank is the right of general lien. Lien is a right of a person to retain goods belonging to another, until the demands of the person in possession are satisfied. Section 171 of the Indian Contract Act confers the right of general lien on the bankers. General lien entitles the banker in possession to retain goods and securities till all its claims against the customer are satisfied. You should note that the banker can exercise his right of general lien only as a banker and not as a bailee. Banker's lien is an implied pledge in the sense that if a default is made by the debtor, the banker can, after giving a reasonable notice to the customer, sell the goods in his possession and recover the amount. If some valuables are deposited with a bank for safe custody, then it is bailment and the bank cannot exercise the right of general lien.

You should note that the right of general lien cannot be exercised in the following cases:

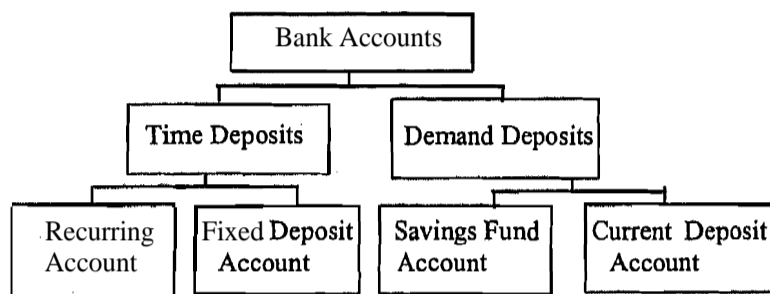
- a) When valuables are deposited for safe custody,
  - b) When money or documents are deposited for a specific purpose,
  - c) When some securities are left with the bank by mistake,
  - d) When the property is held by the customer as trustee and the bank has the notice of trust, and
  - e) When there is an express agreement that the bank shall not exercise the right of general lien.
2. **The Right of Set-off:** Right of set-off is the right of a debtor to adjust the amount due to him from a creditor against the amount payable by him to the creditor to determine the net balance payable by one to another. Like any other debtor, a bank also has a right of set-off. When a customer has two or more accounts in the same name and capacity in a bank, the bank has the right to adjust the amount standing to the credit of the customer against the debit balance in the other account. The bank has a right to combine the two accounts. For example, Mr X has overdrawn his current account to the extent of Rs. 10,000 and he has a credit balance of Rs. 8,000 in his savings account. The bank can combine these two accounts and claim the balance of Rs. 2,000 after adjusting the credit balance of savings account against the debit balance of current account.

3. **Right of Appropriation:** A customer may owe several distinct debts to the bank. When the customer deposits some money in the bank without specific instructions and the amount is not sufficient to discharge all debts, then the problem arises as towards which debt this amount should be adjusted. In the absence of any specific instructions, the bank has the right to appropriate the deposited amount to any loan, even to a time barred debt. But the banker must inform the customer about the appropriation.
4. **Right to Charge Interest and Commission:** The bank has the implied right to charge interest on loans and advances, and also to charge commission for services rendered by the bank. The bank can debit such charges to the customer's account.
5. **Right to Close the Account:** If the bank is of the opinion that an account is not being operated properly, it may close the account by sending a written intimation to the customer.

## 13.6 TYPES OF BANK ACCOUNTS

You have studied that one of the main function of a commercial bank is to accept deposits of money from the public. The deposits accepted by a bank may be classified into two broad categories: (a) time deposits and (b) demand deposits. *Time deposits* are repayable on the expiry of a fixed period of time, while *demand deposits* are repayable on demand. Therefore, as shown in Figure 13.1 the main type of accounts in a bank are fixed deposit account and recurring account (for time deposits), savings bank account and current account (for demand deposits). Let us now see how these accounts are opened in a bank and how are they operated.

Figure 13.1 : Classification of Bank Accounts



### 13.6.1 Fixed Deposit Account

The fixed deposits are the most popular form of deposits raised for the banks. This type of account is most suitable for persons who have spare money to invest for long duration but do not want to invest in risky securities.

The term 'fixed deposit' means the money or deposit is made for a fixed period of time at a fixed rate of interest. This period may vary from forty five days to several years. This period is decided by the customer according to his convenience. The rate of interest is usually higher than other types of deposits. The reason is very clear, because the bank knows that the deposit money is repayable only after a certain period. So the bank need not keep cash reserves more than the statutory requirement against these, thus, the bank can utilise this money more profitably. The rate of interest on fixed deposit depends on the period of deposit, the longer is the period of deposit, the higher will be the interest rate. The interest rate is decided by the Reserve Bank of India from time to time and all banks have to follow that rate structure.

**Opening the account:** For opening a fixed deposit account, the depositor has to fill in an application form available with the bank. The form contains particulars such as name of depositor, the amount of deposit, the period of deposit and the specimen signature. The bank records the rate of interest payable and the due date of repayment. As cheques are not drawn against a fixed deposit account, the banker need not ask for any introduction or reference as to the integrity and respectability of the depositor. After the deposit is received by the bank, an account is opened in the name of depositor in the ledger of the bank and the bank issues a



fixed deposit receipt to the depositor. The **receipt** is an acknowledgment of the receipt of deposit by the bank. A deposit receipt is not a negotiable instrument and **cannot** be treated as a cheque.

**Operation of the Account:** Since the money is deposited for a fixed period of time, **the** amount cannot be withdrawn before the due date. In this type of account no cheque book and pass books are issued. The bank issues only a deposit receipt.

In practice, the banks allow the depositors to withdraw their deposit before the due date. In such cases interest is paid at the rate applicable to the period for which the deposit has already run with the bank less one per cent penalty for premature withdrawal. The depositor can borrow money against the security of fixed deposit receipt.

The fixed deposit receipts are marked 'Not Transferable'. So they cannot be transferred by endorsement. However, it can be assigned in favour of a third party and such an assignee can receive the amount provided the receipt is duly discharged and a proper letter of assignment is given to such person asking the bank to pay the deposit to the assignee on the due date.

When the depositor does not take repayment on the due date, the interest ceases to incur from that date, but the banks may, at their discretion, allow interest thereafter if the deposit is renewed from the date of its maturity till some future date.

If the depositor loses his fixed deposit receipt, he can ask the bank to obtain an indemnity bond from the customer and a note to this effect should be made in the ledger.

### 13.6.2 Current Account

Current accounts are intended for businessmen, joint stock companies, public institutions, etc., whose banking transactions happen to be numerous on every working day. A current account is a running and active account which may be operated upon any number of times during a working day. There is no restriction on the number and the amount of deposits or withdrawals from this account. Since the amount **from** this account is repayable on demand, the banks are required to keep sufficient cash to meet such demands. Therefore, the banks pay no interest on current account deposits. The banks charge incidental charges on an unremunerative current account for the work and expenses involved in its maintenance.

The main advantage of current account is that the customers are relieved from the botheration of handling cash. Third party cheques with endorsements can be deposited in the current account for collection and credit to customer's account. Overdraft facilities are given in this **type** of account and loans and advances are granted by the bank.

#### Opening of a Current Account

Whenever any person or a **group** of persons or a **firm** wants to open a current account with a bank, they have to make a written request in the prescribed form. **The forms** contain the particulars about his name, his address, his trade or profession, his specimen signature and references etc. Before opening a current account in the name of a person, the bank should satisfy itself regarding the customer's character, integrity and respectability. For this purpose, the applicant must be introduced either by a respectable person known to the bank or known to the staff of the branch. If an account is opened without proper introduction, cases of fraud or misrepresentation may occur and the bank and the general public may suffer losses. After all the above **formalities** are over, the bank should receive the initial or first deposit from the customer. When an account is opened, the bank supplies to the customer a 'Pay-in slips book', a cheque book and a pass book. Now in place of the pass book, the banks send to their customers every month a statement of account showing therein the **transactions** that have taken place during the month.

#### Operation of the Account

A customer can deposit money or cheques in **his** account by filling up the requisite pay-in slip. Whenever he wants to withdraw money or wants to make payment to some one, it is done by issuing a cheque. The customer should check up **the** entries in the pass book or statement of account with the counterfoils in his possession.

### 13.6.3 Savings Bank Account

A savings bank account is opened and operated by people who wish to save a part of their income for his **future** needs and also **earn** some interest on his deposits. This type of account is intended to promote the habit of saving among depositors, therefore, some restrictions have been imposed on the number and the amount of withdrawals from this account. The banks allow interest on the minimum balance standing to the credit of an account during the period from the 10th day of the month to the last day of every month.

#### Opening a Savings Bank Account

The procedure of opening a savings bank account is similar to the procedure of opening a current account. For opening a savings bank account, the customer has to fill up the prescribed form, giving details about his name, address, occupation, etc. Before opening the account, the bank should seek proper introduction to satisfy himself about the integrity and respectability of the applicant. The bank should obtain **specimen** signature of the applicant. This account can be opened by depositing a minimum balance prescribed by the bank. The bank then opens an account in his ledger and provides the customer with a pay-in slip book, a cheque book (if customer wants) and a Pass Book.

#### Operating the Savings Bank Account

A customer operates this account through these documents - a pay-in slip (for depositing money in the account), a cheque or withdrawal form (for withdrawing or payment to others) and a pass book. When a cheque book is issued to a customer, he is required to maintain a minimum balance in his account. Interest is payable on the minimum balance according to the rates prescribed by Reserve Bank of India from time to time.

### 13.6.4 Recurring Deposit Account

Recurring deposit accounts are meant for people who have regular monthly incomes. This type of account is intended to encourage the habit of savings among depositors on a regular basis.

In this account, the depositor deposits a fixed sum of money every month for an agreed period and at the end of the specified period, he gets back the amount deposited together with the interest accrued thereon. The amount deposited in this account are in the multiples of **Rs.10**. The period for which a recurring account is opened varies from one year to ten years.

As there is a regular deposit of money into this account and as there is no withdrawal from this account before the expiry of the fixed period, the banks can utilise this money profitably. The rate of interest is higher than in a savings bank account,

The pass book is to be presented to the bank every month when a deposit is made, so as to enable the bank to record the deposit therein.

If a depositor is in need of money before the due date, the bank can on his discretion, repay the amount. Generally, instead of repaying the deposit amount, the bank grant a loan to the depositor against the security of his recurring deposit account. The bank charges interest on such loan at a rate which is one per cent. higher than the rate of interest applicable to the particular recurring deposit.

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#### Check Your Progress A

1. What is a Bank ?

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2. List the main types of-banks.

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3. Define the term 'Customer'.  
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4. What is the position of the bank in the following cases:  
 (a) B deposits a bar of gold for safe custody.  
 (b) B deposits **Rs.10,000** with the bank, directing the bank to buy Units for him.  
 (c) B deposits **Rs.10,000** with the bank in fixed deposit account for one year.
5. Enumerate the important duties of a bank.  
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6. What is banker's right of general lien ?  
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7. List the types of accounts in a bank.  
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8. State whether the following statements are True or False :  
 i) Banks accept deposits for the purpose of lending or investment.  
 ii) **A** company accepting deposits from the public to raise resources for its own use **can** also be called a bank.  
 iii) The bank has an obligation to **refund** deposits on demand.  
 iv) Reserve Bank of India has the sole right of note issue.  
 v) The relationship between a banker and customer is primarily that of debtor and creditor.  
 vi) Introduction is necessary for opening a savings bank account.  
 vii) A bank can disclose the position of a customer's account to any one.  
 viii) The rate of interest is the **maximum** in the case of current account deposits.

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### 13.7 MODES OF MAKING PAYMENTS

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You have learnt that money deposited in an account is repayable on demand. The bank shall make the payment only when a demand is made. A demand can be made by writing a cheque on the bank. Similarly bank drafts are also useful for payments. Banks perform another **important function** of remitting money from one place to another. Let us now study the **meaning** and rules relating to various instruments used for payments through banks.

#### 13.7.1 Cheques

According to Section 6 of **Negotiable Instruments Act, 1881**, "A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand". From this definition it is clear that a cheque is an instrument in writing, containing an unconditional order **to** a bank to pay a certain sum of money on demand to a specific person or according to his order or it may be made payable to the bearer of the instrument. There are three parties to a cheque - drawer, drawee and the payee. A drawer is the person who has an account in the bank and who is writing the cheque. A drawee is one on whom the cheque is drawn, he is liable to make the payment. In case of a cheque paying bank is the drawee. A payee is the person to whom the amount of cheque is to be paid, If the cheque is made payable to **"self"**, the drawer himself becomes the payee.

A cheque may either be a bearer cheque or an order cheque. A bearer cheque is one where the **payment** can be had by the person who is presenting the cheque to the bank for payment. A bearer cheque can be transferred from one person to another by mere delivery only **i.e.**, just like cash payments. On the other hand an order cheque is one which is payable to a certain person or his order. In an order cheque, the payee must be named. An order cheque cannot be transferred from one person to another by mere delivery. It requires the endorsement of the payee.

A cheque is not meant for indefinite circulation. It must be presented for payment within six months of the date appearing on the cheque. If a cheque remains in circulation for a period exceeding six months from the date of issue, it is termed as a "stale cheque" and the bank must dishonour such cheques.

If a cheque bears a date which is yet to come is termed as a post-dated cheque'. A post dated cheque does not become invalid. It is valid and negotiable. But it is **not** payable until the arrival of the date written on it. The banks do not make the payment of a post date cheque because the written order is to be honoured on or after the date mentioned on the cheque.

In order to ensure the payment by cheque absolutely safe, the cheques are crossed. Crossing of a cheque means drawing across the face of the cheque two parallel transverse lines with or without the words "And Company" between the lines. Crossing can be hand written or stamped. When a cheque is crossed, its payment cannot be received at the counter but it is always deposited in the account of the payee.

The paying banker should make the payment of a cheque according to the instructions mentioned on the cheque. The paying banker should not deviate from those instructions. If the bank pays a stale cheque or pays a post dated cheque before the due date, the bank shall not receive the statutory protection. The paying banker should always make the payment in good faith and without negligence.

### 13.7.2 Drafts

Commercial banks are very useful for remittance of funds from one place to another through the network of their branches spread over the entire country. For remitting money from one place to another, banks issue demand drafts on their branches at the place where payment is to be made. It is issued on the request of a customer who has to make a guaranteed payment.

Section 85A of the Negotiable Instruments Act defines a bank draft as "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". A bank draft is, thus, a **payment** instruction similar to a cheque and is always drawn by one branch on another to pay a specified sum of money to the person named therein or his order. You must note that a draft is always payable on demand and it cannot be made payable to bearer. It can be crossed like a cheque.

A bank issues a draft for consideration received in advance. The **person** who intends to remit money has to make an application on the bank's prescribed **form showing** the necessary particulars such as **the name** of the payee, name of the place on which draft is required, amount in words and figure, signature and full **name** of the applicant with address. **The** issuing bank charges a commission for rendering this service **and** the amount of commission depends upon the amount to be remitted. The purchaser then sends the draft to the payee by whom **the** draft is presented to the drawee branch for payment.

You must have noticed that there are three parties to a bank draft: (a) the issuing branch or drawer, (b) paying branch or drawee, and (c) **the** payee. It means that the purchaser of the draft is not a party to the instrument. It is to be noted that this **service** is extended by banks to public in general and the purchaser of the draft need not necessarily be a "customer" i.e., an account holder of **the** bank.

#### Stopping payment of Bank Draft

A bank draft is the issuing bank's commitment in favour of the payee to pay a certain sum of money. Though the bank gives the undertaking at the instance of the purchaser of the draft, who gives due consideration for the same, but a bank draft is equivalent to the bank's promissory note and is accepted because of the credit and faith in the bank which is issuing the draft. The bank should not, therefore, comply **with** 'stop payment' instructions of the purchaser of the draft as readily as that of the drawer of a cheque.

If the bank draft is passed on to the payee, he acquires a right in **the** instrument which cannot be set aside by 'stop payment' instructions of the purchaser. Thus, it is clear that the purchaser of the draft can ask the bank from which he has purchased it to cancel **the** draft and pay back the money to him at any time before **the** draft has been delivered to **the** payee.

### 13.7.3 Standing Instructions

Sometimes a customer gives instructions to his bank to make some payments on his behalf regularly and such instructions are to be carried out till a notice to the contrary is given by the customer. Such instructions are called standing Instructions. Some of the standing instructions are - payment of insurance premium to LIC, membership subscription to clubs, transfer of funds from one account to another, collection of pension on behalf of account holder, collection of interest on Government Securities held in safe custody, collection of dividends on behalf of the customer, etc.

Such instructions which are obtained from the customer in writing, must be clearly and unambiguously worded. The bank is free not to accept standing instructions which are difficult to comply with, but once they are accepted, it is the duty of the bank to carry out the instructions **carefully** and promptly. Once the standing order mandate has been accepted, no further action is required by the customer except that he must keep sufficient **funds** in his account. It is the bank's duty to pay only on the due date. If funds were insufficient to make a payment on the due date, there is no obligation to the customer in respect of that month's payment.

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#### Check Your Progress B

1. Define a cheque.  
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2. What is a Bank Draft ?  
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3. What is the purpose of crossing ?  
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4. Name the parties to a Bank Draft.  
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5. State whether the following statements are True or False:
  - i) A cheque is always payable on demand.
  - ii) An order cheque can be transferred by mere **delivery**.
  - iii) A cheque becomes stale after eight months.
  - iv) A cheque bearing Account Payee crossing can be negotiated.
  - v) A bank draft is drawn by one bank upon another bank.
  - vi) The purchaser of the draft is not a party to the instrument
  - vii)** The bank shall not be liable for not following standing instructions.
  - viii) A bank draft cannot be drawn payable to **the** bearer.

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### 13.8 ADVANCES

You learnt that one of the basic functions of a bank is to lend money. The major portion of the funds mobilised by banks through deposits is employed by way of loans and advances. Advances form the main source of income for a bank. As you know, bank advances enable trade, commerce, industry and agriculture to meet their financial requirements. The banks

follow a cautious policy in advancing loans. Primary concern of a bank as a lender should be 'safety' and 'liquidity' of advances. Besides, banks also need a good return from the employment of their funds to meet their expenses. This is known as 'profitability'. Banks have to maintain a balance between liquidity and profitability in such a way that **they** should be able to meet the demand of depositors for cash and at the same time **earn** sufficient profit **from** the advances.

Naturally the banks should not lock up the funds in few investments for a long period of time. This is risky from the point of view of safety of investments. There is common saying that one should not put all eggs in one basket. Banks provide various types of advances to its customers according to their needs and repaying capacity. The advances may be in any of the following four forms: (1) loans, (2) overdrafts, (3) cash credits, and (4) discounting of bills. Let us briefly discuss about them one by one.

### 13.8.1 Loans

**A loan is a financial arrangement under which an advance is granted by the bank to the borrower on a separate account called the loan account.** When a loan is granted against security or otherwise, the entire amount of loan is paid to the borrower in lump sum either in cash or by transferring the amount to his account in the bank. Whenever borrower repays some money, the loan account is credited by that amount and the loan account is debited with the amount of interest and incidental charges. Interest is charged on the whole amount of loan sanctioned, irrespective of the amount actually withdrawn by the **borrower**. However, the rate of interest on loan is slightly lower than that charged on an overdraft and a cash credit.

Loans are sanctioned for short, medium and long periods. Loans repayable within a period of one year are called **short term loans**. They are suitable to meet the working capital needs of the business firms. Loans repayable within a period ranging from one to five years are termed as **medium term loans** and such loans are granted to finance expansion and development plans. Commercial banks normally grant short **term** and medium term loans only. When a loan is given for more than five years, it is called a **long term loan**.

The loans to individuals are granted on the basis of personal security and guarantee by another person. Loans to trade, industry or agriculture are granted against tangible and intangible securities. **A secured loan or an advances** means a loan or an advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance.

The banks prefer to grant loans because of the following three reasons: (1) the bank can collect interest on the entire amount of loan sanctioned, (2) it involves very little accounting work, (3) the bank can review the loan account periodically. The main drawback of the loan system is that every time a loan is needed, it is to be negotiated afresh. Further, the banks have no control over the use of funds borrowed by the customer.

From the point of view of the borrower, the big advantage of taking a loan is that money will always be available over the agreed period and **cannot** be recalled as a result of restrictions imposed on bank lending. However, the main disadvantage to **the** borrower is that he is required to pay interest on the entire amount of loan, **whether** he has actually withdrawn the amount or not.

### 13.8.2 Overdraft

An overdraft is a financial arrangement under which a current account holder is permitted by the bank to withdraw more than the credit balance in his account, **upto** an agreed limit. Thus, by nature, it is a temporary financial accommodation to be made use the customer occasionally. The overdraft facility is given to those who have a current account with the bank and whose business relations with the bank continue to be good. Besides that, bank also considers the business of the customer, his reputation, how far the arrangement will help the customer to improve his business, **and** ability to repay the **money** to the bank.

An overdraft is granted either **against** collateral securities or against the personal security of the borrower. An overdraft arrangement is very advantageous to the borrower as interest is

charged on the amount actually overdrawn by him. But it is not advantageous to the bank because, while he can charge interest on the amount actually **overdrawn**, he is required to keep at the disposal of the customer the full amount of overdraft sanctioned. In order to protect the interest of the banker agreement a minimum interest clause is included in the agreement, which requires the customer to pay a **minimum** rate of interest on the sanctioned amount of overdraft, if the overdraft is not utilised fully.

Bank should be very careful while granting overdraft facility to a customer, because in case of default by the customer to repay the overdraft, the bank has to go through long legal **formalities**. In order to be safe, the banks generally obtain a promissory note from the customer.

### 13.8.3 Cash Credit

Cash credit is the main method of lending by banks in India. Cash Credit is a financial arrangement between the bank and the customer under which a bank allows his customer to borrow money **upto** a certain limit against the security of tangible assets or guarantees. The amount is credited to a separate account and the customer is allowed to operate the account.

In the case of cash credit, the borrower need not withdraw the whole amount at once. He **can** withdraw the amount in **instalments** as and when needed. Further, **he** can deposit into the account any surplus amount which he has in **his** hands. Thus, you note that it is an active running account to which deposits and withdrawals may be effected frequently. However, **the** debit balance in a cash credit account on any day should not exceed the cash credit limit. A cash credit is usually a more permanent financial arrangement than an overdraft.

In the case of cash credit, interest is charged not on the amount of cash credit sanctioned to him, but on the amount actually utilised by **him** for the actual period of utilisation.

Though the cash credit arrangement is very popular with borrowers, it is disadvantageous to the bank. While bank can charge interest only on **the** actual **amount** utilised by the borrower, but he has to keep at the disposal of **the** borrower the entire amount of cash credit sanctioned. For this reason, there is a provision of charging commitment charge on the unutilised portion of the cash credit limit. Normally, the **minimum** interest clause is included in the cash credit arrangement. However, it is very **difficult** for the bank to verify the end-use of the loan.

### 13.8.4 Discounting of Bills

**Discounting of bills** of exchange is another important form of lending. Under this system the bank takes a bill of exchange maturing within a **short** time, say **60** days or **90** days and credits **the** customer's account with **the amount** of the bill after some discount. The bank waits **upto** the date of maturity of the bill and presents it on the date of maturity to the **drawee** for payment. Since the bank has to wait till the date of maturity, the banks charge interest for the remaining duration of the bill and this amount is known as 'discount'. For example, a bill of **Rs.5,000** payable after **3** months is discounted @ **6** per cent, the bank will credit **the** customers account with **Rs.4,925** only.

Banks normally accept only such bills which are considered eligible for discount under the directions of Reserve Bank of India. The bills **mostly** discounted are documentary bills i.e., a bill of exchange accompanied by documents of title to goods. In case the bill is dishonoured on the due date, the bank recovers the amount of the bill together with interest and other charges from the customer. **The** bank has to take care that the dishonoured bills are immediately sent to the **customer** to enable him to take the necessary legal action.

The main advantage of discounting of bills is that, though the bank has no tangible assets with it as security, the bank can recover the full amount of the bill from the customer by debiting his account. It is a method of short-term financing. The bank is certain that after the stated period, the amount will be realised, so the bank can utilise its funds **more** profitably.

You notice from the above that discounting of bills is a method of financial **accommodation** by the bank to the customer. It helps the customer to carry on his business smoothly without **bothering** about the problem of money.

While lending money, the bank has to keep three principles in mind viz., liquidity, safety and profitability. In order to minimise risks in advancing money, banks usually insist on good security and would like to create a charge on the tangible assets of the borrower in favour of the bank. When a charge is created, the bank gets certain rights on the tangible assets. In case the borrower fails to repay the advance, the bank can recover its money by disposing of those assets in the market. The important methods of creating a charge are: (1) pledge, (2) hypothecation, and (3) mortgage. Let us now study them briefly.

### 13.9.1 Pledge

Section 172 of the Indian Contract Act defines pledge as "a bailment of goods as security for payment of a debt or performance of a promise". So, a pledge is a contract whereby a borrower delivers his movable property to the lender as a security for the loan on the understanding that the property pledged will be returned to the borrower on repayment of the debt. The borrower who pledges the property is called the 'pledger' or 'pawner' and the person with whom the property is pledged is known as 'pledgee' or 'pawnee'.

From the above, you must have understood that delivery of goods and return of goods are the two essential features of pledge. Delivery of goods may be either physical delivery or constructive (symbolic) delivery. When the pledger puts his own lock on the godown or when the keys of the lock are handed over to the bank, it amounts to delivery of goods. Similarly, handing over the duly endorsed documents of title to goods like railway receipt, bill of lading, etc., amount to delivery of goods.

While accepting a pledge as a charge, the bank should ensure that the contract is in writing to minimise the misunderstanding of the terms. The contract should be complete in all respects and should incorporate all the usual clauses of pledge. It is advisable for the bank to get a declaration from the borrower to the effect the goods deposited with the bank are left as a security for the advance. The bank should see that the borrower has a valid title to the property pledged. The bank should ensure that the goods are kept safely in the godown. It is desirable that the bank should ensure goods against theft, fire, riot, etc.

You must remember that when goods are pledged, only the possession over the goods is given and not the ownership. The pledger or the borrower continues to be the owner of the property.

If the borrower failed to repay the loan in time, the bank has a right to file a suit against the borrower for the recovery of the amount, and retain the goods as collateral security. But since this is a lengthy process, the banks are given the right to sell the pledged goods and recover their money. But before selling the goods, the bank must give a reasonable notice to the borrower about his intention to sell the goods.

If the proceeds of sale are less than the amount due, the borrower is still liable to pay the balance. But if the proceeds of sale is in excess of the amount due, the bank has to pay the surplus amount to the borrower. In case the goods are sold without giving a reasonable notice to the borrower, the sale cannot be set aside, but the bank will become liable to the borrower for damages.

From the above, it must be clear to you that for securing a charge on the property, the method of pledging is very simple and therefore, it is very popular. It should also be noted that the right to retain the goods pledged is applicable only in case of a particular debt for which the goods are pledged. The bank has no right to retain the security, as security for other debts owned by the borrower.

### 13.9.2 Hypothecation

Hypothecation is a mode of creating charge on goods or related documents without the surrender of possession of goods. According to Prof. Herbert Hart, "Hypothecation is a legal transaction whereby goods may be made available as security for a debt without transferring either the property or the possession to the lender".



Hypothecation is resorted to such cases where transfer of possession of the property from the borrower to the creditor is either impracticable or inconvenient. For example, if the borrower wants to borrow on the security of motor vehicle, which is being used as a taxi, it shall not be advisable to pledge the vehicle with the bank, as it will deprive him of his livelihood. In the case of hypothecation, an equitable charge is created on the goods for the amount of debt but the hypothecated goods actually remain in the physical possession of the borrower. The borrower who hypothecates the goods is known as 'hypothecator' and the lender is termed as 'hypothecatee'.

Generally, hypothecation is done by the borrower by executing a document called a 'letter of hypothecation' in favour of the lender. In this letter it is stated that the said goods or property are at the order and disposition of the lender until the debt is cleared. It also empowers the lender to sell the hypothecated property in the event of default or repayment by the borrower.

As the **hypothecated** goods remain in the possession of the borrower, there is considerable scope for fraud. The same goods may be hypothecated with another person. It is a risky method no doubt. That is why this facility is granted to parties of unquestionable integrity and honesty. Even then the banker should obtain a declaration from the borrower to the effect that the goods are not hypothecated earlier with some other lender and that the borrower has a clear title to the property hypothecated. The bank should carry out regular inspection and physical verification of the hypothecated goods.

### 13.9.3 Mortgage

When immovable property like land and building is offered as security for debt, a charge is created thereon by means of a mortgage. A mortgage is the transfer of **the** interest in a specific immovable property by one person to another for the **purpose** of securing an advance of money. The transferor is called 'mortgagor' and the transferee is known as 'mortgagee'. The advance of money in respect of which the mortgage is effected is called the '**mortgage** money' and the instrument by which the mortgage is effected is called the 'mortgage deed'.

In a mortgage, the possession of the property need not always be **transferred** to the mortgagee. Usually, it remains with the mortgagor. Since the mortgagee gets the interest in the property, he has a right to sell of the property and recover his loan. When the borrower repays the amount of loan together with interest, the interest in the property is re-conveyed to the mortgagor.

While accepting a mortgage as a charge, the bank should ensure **that** the borrower has a valid title to the property and this can be done by examining the original title deeds. The bank must not part with the title deeds to the borrower when the mortgage is pending. If the advance against mortgage is given to a joint stock company, then the charge should be registered with the Registrar of Companies within 30 days of the creation of the charge. The mortgaged property should be inspected periodically to ensure that it is in good condition. If the property mortgaged is building, the bank should ensure that it is insured against **fire**, riot etc.

There are several forms of mortgage. **They** are (i) simple mortgage; (ii) Usufructuary mortgage; (iii) English mortgage; (iv) Mortgage by conditional sale; (v) Equitable mortgage or mortgage by deposit of title deeds and (vi) anomalous mortgage.

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## 13.10 OTHER BANK SERVICES

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Apart from performing the main functions of accepting deposits and granting advances, the banks have started performing various other services to the customers. Such other services are as follows:

1. Collection of money on behalf of customers: A bank undertakes the responsibility to collect money on behalf of his customers. Banks collect cheques and bank drafts, **and** credit the proceeds to the customers' accounts. Banks also collect bills of exchange, promissory notes, postal orders, interest and dividend warrants on behalf of the customers. Banks even collect the salaries of his customers from their employers, when

they are away from their place of employment or are on leave. They often collect pension of the customers from their former **employers** and credit it in their account. At times, **the** banks collect even the rent due to the customer from his tenants and credit the amount to their accounts.

2. Leasing: A lease is the use of an asset which belongs to some other person. In a lease contract, the possession and use of asset vests with the user called the 'lessee', whereas the ownership remains with the provider called the 'lessor'. In simple words, leasing is a system by which a person gets the right to use an asset by paying a predetermined amount of money called 'rental' periodically over a period of time.

The banks have undertaken this business in a big way. The main advantage of leasing to a business is that, although the legal title of the asset remains with the leasing company, once the first rental has been paid, the business **firm** gets the physical possession of the asset to put it on operation. has complete use of the asset without having to finance its acquisition out of its own valuable resources or to seek a loan to cover the cost. In this **arrangement** business firm need not spare the financial resources at a time to acquire the asset or seek a loan to cover the cost.

3. Tax Consultancy: This service is of a recent origin and provides advice on income tax and other personal taxes such as capital gains tax, wealth tax, etc. **The** bank's tax department offers advice on tax matters which consist of preparing the customer's annual statement of **income** and expenditure, claiming allowances as permitted, claiming the rebates, etc. The tax department also advises the customers as to **how** to arrange **their** affairs to the best advantage to themselves. The bank advises the customer regarding life insurance and **other** investments so as to reduce the tax burden.
4. Merchant **Banking** Services: Until a few years back this service was **confirmed** to few larger banks. But now it has become part and parcel of business of almost every bank. This service comes under rendering non-banking services to industrial and **business** houses. For this purpose banks have set up merchant banking divisions.

Merchant banking division of a bank offers to industrial and business houses, under one roof, a wide range of non-banking services such as **conducting** of economic, technical and financial feasibility studies. It helps **in** undertaking **market surveys**. It helps its clients to obtain from the Government and other departments letters of intent, licences and permission required for setting up the industrial projects. This service also includes advising the clients as to **the** methods and **terms** of raising capital, organising the public issue arranging for the underwriting, etc.

5. Issuing of Credit Cards: Credit cards are issued by banks as a method of making payment without using a cheque. Credit cards provides instantaneous credit facilities to the card holder, The card holder can buy goods and services immediately but paying for them later. A specially designed plastic card is issued to **the** card holder on which the name of the holder, **name** of the issuing bank, card number and his or her signatures are inscribed.

Each card holder is given a credit limit on his credit card account. Payment for goods and services through credit cards be made at establishments which are members. Such shops, hotels, travel agencies, railways airlines, etc., usually display the signs of the credit cards accepted by them.

**When** a card holder makes purchases against the credit card, he is required to sign **the** sales voucher. The shop-keeper prepares the sales voucher which contains all details such as name of the credit card holder, credit card number, date of transaction, value of sales made or services rendered. Then the shop keeper compares the signature of the credit card holder in the sales voucher with specimen signature on the card. On being satisfied with its authenticity of **the** signature, he gives a copy of the voucher to the card holder and hands back the card. The retailer sends his copy of the sales voucher to the issuing bank for payment and receives the payment. After the **payment** is made the bank debits the account of the credit card holder. Each month a statement is sent to the card holder giving details about the transactions made by him. The card holder can make the full payment or he can pay a certain minimum amount and can carry forward the remaining balance to the **next** month, for which bank charges a certain amount of interest. Thus, the card holder gets the facility of credit.

The credit card system is advantageous to the business establishments in terms of increased sales turnover, assured payment, less bad debts, etc. Credit card business is also profitable for the issuing bank, as it gets commission upto 4% on each transaction.

The credit card holder is insured by the bank upto certain limits. Banks also permit the card holder to withdraw money from any of its branches all over the country. In the case of the banks which have automatic money withdrawal counters called 'Any Time Money (ATM)' card holders can withdraw money, round the day. Whenever the card holder wants to withdraw cash through ATM, he has to feed in his personal identity number along with the card, and can get cash. However, at present the facility of ATM is available only in major cities like Delhi, Calcutta, Bombay, Madras, Bangalore, etc.

Now most of the banks have introduced computers to facilitate the customers. For speedy cheque clearing, Magnetic Ink Character Recognition (MICR) cheques are used. Under this system cheques are processed at high speed on machines. So with computerisation the work is done quickly. The energies of the bank staff can be utilised towards more productive, innovative and developmental areas. All this put together will contribute towards greater business development, higher productivity and much greater customer efficiency.

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**Check Your Progress C**

1. What is the difference between Overdraft and Cash Credit ?  
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2. What is discounting of bills ?  
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3. List the forms of banker's advances.  
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4. Enumerate three important methods of creating a charge.  
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5. What is hypothecation ?  
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6. State whether the following statements are True or False.
  - i) Loans are sanctioned for short term only.
  - ii) The borrower has to pay interest on the entire amount of loan.
  - iii) The rate of interest on loan is slightly lower than that charged on an overdraft.
  - iv) Cash credit is an active running account.
  - v) Discounting of bills is a method of long-term financing.
  - vi) In case of pledge only possession is given not the ownership.
  - vii) In case of Hypothecation the goods are handed over to the bank.
  - viii) Movable goods can be mortgaged to the banks.
  - ix) Credit cards are issued by retailers.

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**13.11 LET US SUM UP**

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Bank is an institution which accepts deposits from public which are repayable, and lends the money to those who need it. Banks may be commercial banks, co-operative banks, Land Development Banks, Rural Banks, Industrial Banks and Central Bank.

Banks play a very important role in the economic development of the country. They encourage habit of savings among people. We can make payments easily and safely through banks. Banks provide different types of credit facilities to its customers. Money can be remitted to at far of places with the help of banks.

A customer is one who has an account with a bank. The relationship between the banker and the customer is of a contractual nature whereby the banker is the debtor and the customer is the creditor. When bank accepts goods for safe custody, **then** the relationship is that of the bailor and bailee. Banks **perform** many agency functions on behalf of its customers such as collection of cheques and drafts, payment of insurance premiums, etc.

The bank has some obligations towards its customers. **The** most important obligation is to honour the cheques of its customers. The bank is under an obligation to maintain utmost secrecy about the position of the customer's account. But under certain circumstances the bank can disclose the position. The bank must follow the instructions of its customer. It is the duty of the bank to maintain accurate records of all transactions of the customer with the bank.

The Indian contract Act has given the right of general lien to the banks. The banks can retain **any** property of its customer till its **claims** are satisfied. The bank has the right to combine the two accounts of a customer to determine the net amount outstanding. Though banks allow interest on the credit balance, it has the right to charge interest on loans, overdrafts, etc.

Broadly, three types of accounts can be opened in a bank **viz.**, fixed deposit account, **current** account and savings bank account. Fixed deposit account is meant for those who have spare money and who wants to earn without taking any risk. The amount of deposit is repaid by **the** bank with interest on the expiry of pre-determined period. A current account is suitable for businessmen who can deposit and withdraw money from **their** account as many times as **they** like, provided they have credit balance in their account. A savings bank account is meant to encourage the habit of savings.

The banks advance money in the form of loans, overdrafts, cash credits and **discounting** of bills. **The** banks lend money for short term, **medium** term and **long-term**. While advancing a, loan, the banks have to ensure that it will **be** paid back. the banks keep in mind the three points while lending money - liquidity, safety and profitability. The banks generally create some charge on the tangible assets of the borrower. It ensures that in case the **borrower** makes a default it can recover money by selling the property. **The** different methods of creating a charge are - pledge, hypothecation and mortgage.

In case of pledge of goods, the goods remain in the possession of the bank. The bank gets **the** right to recover the money by selling the pledged goods in the market. But before selling the goods, a reasonable notice has to be given to the borrower. In case of hypothecation of goods, the goods are allowed to remain in the possession of the borrower, only an equitable charge is created on them. The practice of mortgage is adopted when immovable property is offered as a security. In case of mortgage, the possession is **not** transferred but the bank gets the **general** interest in the property and so the bank can sell the property to recover **the** money.

Besides providing loans and advances, banks also render **some** other useful services. They collect money on behalf of customers and make payments according to their instructions. Banks have entered into the leasing business also. The banks provide merchant banking services to its big customers. The banks have introduced the credit card facility for its customers whereby the customer can make purchases without paying cash immediately.

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## 13.12 KEY WORDS

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Bank: An institution which accepts deposits from public repayable on **demand** and invests or lends the money. It also provides various **other services** to its customers.

Customer: A **person** who has an account with the bank.

General Lien: Right to retain any property belonging to the other till all dues are cleared.

Cheque: An instrument used for withdrawing **money from** bank. It is an unconditional order in writing on the specified bank by its customer, instructing the bank to pay the amount specified therein to the person named therein or to his order.

Pass **Book: A** book supplied by the bank to its customers showing his transactions with the bank.

Standing Instructions: Instructions to the bank for making **certain** payments and collections regularly on behalf of the customer.

Bank Draft: An instrument drawn by **one** branch of a bank upon another branch of the same bank, directing the other branch to pay the amount mentioned therein to the person named or to his order.

**Overdraft:** An arrangement between the bank and its customer **where the** customer can withdraw **from** the bank more money than is available in his account.

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### 13.13 ANSWERS TO CHECK YOUR PROGRESS

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- A. 4) (a) bailee (b) an agent (c) debtor  
8) i) True ii) False iii) **True** iv) True v) True vi) True vii) False viii) False
- B. 5) i) True ii) False **iii) False** iv) False **v) False** vi) True **vii) False** viii) True
- C. 6) i) False ii) **True** iii) True iv) True v) False vi) True **vii) False** viii) False ix) False

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### 13.14 TERMINAL QUESTIONS

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1. **Define** the term "Banker". Explain briefly the **functions** of a modern commercial bank.
2. Who **is** a customer ? When does a person become the customer of a bank ?
3. Explain briefly the various types of banks.
4. What is the relationship between a banker and his customer ?
5. "The relation between a banker and customer is primarily that of a debtor and creditor". Discuss.
6. Explain the nature of banker's right of lien.
7. Explain the rights and obligations of a bank.
8. Discuss various ways in which a commercial bank renders financial assistance to business.
9. Discuss the various modes of creating charges.
10. Distinguish between:
  - i) Pledge and Hypothecation
  - ii) Hypothecation and Mortgage.
  - iii) Loan and Overdraft
  - iv) Cash Credit and Overdraft

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

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## UNIT 14 BUSINESS RISK AND INSURANCE

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### Structure

- 14.0 Objectives
- 14.1 Introduction
- 14.2 What is a Business Risk
- 14.3 Pervasiveness of Risks in Business
- 14.4 Types of Business Risks
- 14.5 Risk Management
- 14.6 What is **Insurance**
- 14.7 Insurable Risks and Non-insurable Risks
- 14.8 Contract of Insurance
  - 14.8.1 Components of an Insurance Contract
  - 14.8.2 Legal Aspects of Insurance
- 14.9 Kinds of Insurance
  - 14.9.1 Life Insurance
  - 14.9.2 Marine Insurance
  - 14.9.3 Fire Insurance
  - 14.9.4 Motor Insurance
  - 14.9.5 Miscellaneous Insurance
  - 14.9.6 Difference between Life Insurance and Other Insurance
- 14.10 Let Us Sum Up
- 14.11 Key Words
- 14.12 Answers to Check Your Progress
- 14.13 Terminal Questions

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### 14.0 OBJECTIVES

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After studying this unit, you should be able to:

- define business risk and explain the pervasiveness of risks in business
- identify various types of business risks and state the process of risk management
- define insurance and identify insurable and non-insurable business risks
- state the components of an insurance contract and the legal aspects of insurance
- explain various kinds of insurance and identify their suitability for different purposes in business.

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### 14.1 INTRODUCTION

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As you know that all human activities which eliminate the hindrances and facilitate the flow of goods from producers to consumers come under '**aids-to-trade**' or '**auxiliaries to trade**'. The whole range of activities coming under aids-to-trade are classified under five categories viz., transportation, warehousing, insurance, advertising and banking. You have already studied about advertising in Block 3 and about transportation and warehousing in the previous units in this block. In this unit you will study about insurance. This unit discusses in detail the meaning and types of business risks, and various aspects of insurance such as meaning, contract, legal aspects, and types.

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### 14.2 WHAT IS A BUSINESS RISK

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The term 'risk' has been **defined** by different people in different ways. For this reason there is no single standard definition of this term which is universally used. The term is used to refer to (a) an insured object such as a home or a car, (b) a peril such as fire or earthquake, (c) the probability of an event which may cause loss, (d) the loss itself, (e) the hazardous condition, (f) the variation in the outcome that could