

# **BANKING THEORY LAW & PRACTICE**

## **UNIT - I**

Origin and development of banks- Banking Regulations Act 1949-Definition of Banking-Licensing- Opening of branches - Importance and Functions of Banks - Inspection. Relationship between Banker and Customer- Special types of Banker's Customers.

## **UNIT - II**

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## **UNIT - III**

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## **UNIT – V**

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# Unit \_ 1

## Origin and Development of Banks

### Origin of the Banks

1. BANCK-German word-it means- joint stock fund
2. BANCO-Italy-heap of money
3. BANCUS/BANQUE-French-bench
4. BANK-English-financial intermediary that accepts deposits and channels those deposits into lending activities.

### The Development of British Banking

1. Royal exchanger in England-in England, Edward III ,exchange the Foreign coins The goldsmiths-started banking
2. Early beginning of "Issue" and "Deposit" banking
3. Current account

### Definition of Banking

Section 5(b) of the Banking companies act,1949 defines banking as "accepting for the purpose of lending or investment of deposits of money received from the public ,repayable on demand and withdrawable by cheque , draft, order or otherwise".

## **Growth of Indian Banking**

- \* General bank of India set up 1786-followed by bank of Hindustan and Bengal bank.
- \* East India company established bank of Bengal 1809
- \* then Bombay bank 1840.
- \* Bank of madras 1843.
- \* All three banks amalgamated in 1920 -imperial bank established.
- \* Punjab national bank ltd-1894 for Indian.
- \* RBI in 1935.
- \* 1955,14 comm. Bank nationalized.
- \* 1980 banking reforms carried out.
- \* 1991 ATM.

## **Banking Regulation act,1949**

- \* The banking regulation act, 1949 is a legislation in India that regulates all banking firms in India. Passed as the banking companies act 1949,it came into force from 16 march 1949 and changed to banking regulation act 1949 from 1 march 1966.it is applicable in Jammu and Kashmir from 1956.initially, the law was applicable only to banking companies. But, 1965 it was amended to make it applicable to cooperative banks and to introduce other changes.

## Functions of Bank

In competitive exams, the topic functions of the bank form an important part of the question paper and its knowledge is crucial to score good marks.

Especially, candidates appearing for various bank exams such as IBPS Exam, SBI Exam or RBI exam definitely encounter questions related to important banking functions in the paper or at the time of interview.

For other graduate-level government examinations such as the SSC exam, the questions related to bank functions are asked under professional knowledge heading. Therefore, this article will walk you through important banking functions, their categories and more.

Candidates preparing for any competitive or government exams can check the following links for their preparation:

## Meaning of Bank

A bank is a lawful organisation that accepts deposits which can be withdrawn on demand. Banks are institutions that help the public in the management of their finances, public deposit their savings in banks with the assurance to withdraw money from the deposits whenever required.

Banks accept deposits from the general public and from the business community as well and give two assurances to the depositors –

1. Safety of deposit
2. Withdrawal of deposit, whenever needed

Banks give interest on deposits which adds to the original deposit amount and is a great incentive to the depositor. This promotes saving habits among the public. Bank also grants loans based on the deposits thereby adding to the economic development of the country and well being of the general public. With this stature, it becomes important to understand the major functions of a bank.

Candidates can check the important [Banking Abbreviations](#) in the linked article.

Aspirants preparing for various government exams can check the important topics given below:

## Important Functions Of Bank

There are two types of functions of banks:

1. Primary functions – being primary are also called banking functions.
2. Secondary Functions

Both the types of functions of bank are explained below in detail:

# Primary Functions of Bank

All banks have to perform two major primary functions namely:

1. Accepting of deposits
2. Granting of loans and advances

## Accepting of Deposits

A very basic yet important function of all the commercial banks is mobilising public funds, providing safe custody of savings and interest on the savings to depositors.

Bank accepts different types of deposits from the public such as:

1. **Saving Deposits:** encourages saving habits among the public. It is suitable for salary and wage earners. The rate of interest is low. There is no restriction on the number and amount of withdrawals. The account for saving deposits can be opened in a single name or in joint names. The depositors just need to maintain minimum balance which varies across different banks. Also, Bank provides ATM cum debit card, cheque book, and Internet banking facility. Candidates can know about the [Types of Cheques](#) in the linked page.
2. **Fixed Deposits:** Also known as Term Deposits. Money is deposited for a fixed tenure. No withdrawal money during this period allowed. In case depositors withdraw before maturity, banks levy a penalty for premature withdrawal. As a lump-sum amount is paid at one time for a specific

period, the rate of interest is high but varies with the period of deposit.

3. **Current Deposits:** are opened by businessmen. The account holders get overdraft facility on this account. These deposits act as a short term loan to meet urgent needs. Bank charges a high-interest rate along with the charges for overdraft facility in order to maintain a reserve for unknown demands for the overdraft.
4. **Recurring Deposits:** A certain sum of money is deposited in the bank at a regular interval. Money can be withdrawn only after the expiry of a certain period. A higher rate of interest is paid on recurring deposits as it provides a benefit of compounded rate of interest and enables depositors to collect a big sum of money. This type of account is operated by salaried persons and petty traders.

## **Granting of Loans & Advances**

The deposits accepted from the public are utilised by the banks to advance loans to the businesses and individuals to meet their uncertainties. Bank charges a higher rate of interest on loans and advances than what it pays on deposits. The difference between the lending interest rate and interest rate for deposits is bank profit.

Bank offers the following types of Loans and Advances:

1. **Bank Overdraft:** This facility is for current account holders. It allows holders to withdraw money anytime more than available in bank balance but up to the provided limit. An overdraft facility is granted against collateral security. The interest for overdraft

is paid only on the borrowed amount for the period for which the loan is taken.

2. **Cash Credits:** a short term loan facility up to a specific limit fixed in advance. Banks allow the customer to take a loan against a mortgage of certain property (tangible assets and / guarantees). Cash credit is given to any type of account holders and also to those who do not have an account with a bank. Interest is charged on the amount withdrawn in excess of the limit. Through cash credit, a larger amount of loan is sanctioned than that of overdraft for a longer period.
3. **Loans:** Banks lend money to the customer for short term or medium periods of say 1 to 5 years against tangible assets. Nowadays, banks do lend money for the long term. The borrower repays the money either in a lump-sum amount or in the form of instalments spread over a pre-decided time period. Bank charges interest on the actual amount of loan sanctioned, whether withdrawn or not. The interest rate is lower than overdrafts and cash credits facilities.
4. **Discounting the Bill of Exchange:** It is a type of short term loan, where the seller discounts the bill from the bank for some fees. The bank advances money by discounting or purchasing the bills of exchange. It pays the bill amount to the drawer(seller) on behalf of the drawee (buyer) by deducting usual discount charges. On maturity, the bank presents the bill to the drawee or acceptor to collect the bill amount.



# Secondary Functions of Bank

Like Primary Functions of Bank, the secondary functions are also classified into two parts:

1. Agency functions
2. Utility Functions

## Agency Functions of Bank

Banks are the agents for its customers, hence it has to perform various agency functions as mentioned below:

**Transfer of Funds:** Transferring of funds from one branch/place to another.

**Periodic Collections:** collecting dividend, salary, pension, and similar periodic collections on the clients' behalf.

**Periodic Payments:** making periodic payments of rents, electricity bills, etc on behalf of the client.

**Collection of Cheques:** Like collecting money from the bills of exchanges, the bank collects the money of the cheques through the clearing section of its customers.

**Portfolio Management:** banks manage the portfolio of their clients. It undertakes the activity to purchase and sell the shares and debentures of the clients and debits or credits the account.

**Other Agency Functions:** under this bank act as a representative of its clients for other institutions. It acts as an executor, trustee, administrators, advisers etc. of the client.

## Utility Functions of Bank

- Issuing letters of credit, traveller's cheque, etc.
- Undertaking safe custody of valuables, important documents and securities by providing safe deposit vaults or lockers.
- Providing customers with facilities of foreign exchange dealings
- Underwriting of shares and debentures
- Dealing in foreign exchanges
- Social Welfare programmes
- Project reports
- Standing guarantee on behalf of its customers, etc.
- Candidates can check the [Types of Banks](#) in India in detail.
- Knowledge of major functions of a bank is important from an exam point of view. Candidates appearing for any competitive or government exam can check the links given below:
- Candidates can check [Previous Year Question Papers](#) with solution PDF to understand the type of questions related to banking functions asked in the general awareness section of these examinations.
- For further information on various competitive exams go through the given links:

# Sample Questions on Functions of Banks

A part of the General Awareness section is also dedicated to Banking Awareness, especially for banking sector exams. So preparing topics like this are important from the competitive examination point of view as well.

Thus, to help aspirants understand the type of questions which may be asked or the pattern in which they may be asked, given below are a few sample questions based on the functions of the bank.

**Q 1.** What is the ratio between the total assets maintained by the bank to the total cash in hand called?

1. Statutory Liquid Ratio
2. Cash Reserve Ratio
3. Balance Reserve Ratio
4. Debit-Credit Ratio
5. None of the above

**Answer: (1) Statutory Liquid Ratio**

**Q 2.** Which of these is not a function of Public Sector Banks?

1. Transferring Money
2. Opening Bank Accounts
3. Lending Money to people in the form of Loan
4. Letting customers open up lockers
5. Issuing currency

**Answer: (5) Issuing Currency**

**Solution:** Only the Reserve Bank of India controls the issue and flow of currency

**Q 3.** Which among the following is not a function of Regional Rural Banks?

1. RRBs have been set up for better banking facilities to rural people
2. Disbursement of wages of MGNREGA workers
3. Provide banking assistance to semi-urban areas
4. All of the above
5. None of the above

**Answer: None of the above**

**Q 4.** Which body is responsible to regulate the functioning of all Banks in India?

1. Government of India
2. State Bank of India
3. Reserve Bank of India
4. Ministry of Finance
5. Bank Unions

**Answer: (3) Reserve Bank of India**

**Q 5.** Which was the first bank to be established in India?

1. Bank of Bharat
2. Indian National Bank
3. Central Bank
4. State Bank of India
5. Bank of Hindustan

**Answer: (5) Bank of Hindustan**

Mainly multiple-choice questions are only asked based on Banking Awareness, so candidates must prepare themselves accordingly. This section can be the most

scoring and affect the overall performance in the competitive exams.

# The General Relationship between Banker and Customer

The opening of an account with a banker, and the banker's acceptance for such opening of account gives rise to a 'contractual relationship'. The relationship between the banker and customer is, generally, like a '*Commercial Transaction*'. The relationship between a banker and a customer is the foundation on which mutual duties, liabilities and privileges are being built. An understanding of these terms is essential.

- 1. Debtor-Creditor Relationship:** When a customer (debtor) deposits money with a bank (creditor), the customer becomes a lender and the bank becomes borrower. As such, the relationship is that of a debtor and creditor. It is a general relationship between banker and his customer. Some important points to note in Debtor-Creditor Relationship are,

- The banker is the debtor of the customer with the obligation to honor his customer's cheque drawn upon his balance.
- When the banker lends money to his customer, the customer becomes the debtor and the banker, the creditor.

2. **Banker as an agent** : Generally, bankers render agency services for their customers. They pay insurance premium, electricity bills, taxes, etc. They collect interest on investments, dividends on shares, collect cheques, etc. Bankers act as per the 'Standing instructions' of their customers. For these services, the banker charges a nominal commission from the customer. The banker, by providing these services acts as an agent and the customer who gives the standing instructions, acts as a principal. Hence, the relation of banker and customer is that of agent and principal as far as these services are concerned.

3. **Creditor (i.e., customer) demanding payment** : Under a commercial debt, the liability of the debt arises only at the maturity of the debt i.e., on the due date. The debtor i.e., the banker is to pay the debt on the maturity date. The customer must demand in writing for repayment, only then, will the payment be made to the customer.
  
4. **Banker as a bailee** : Bailee is one who possesses goods or articles on behalf of the owner (*called bailor*) of the goods. According to the Sec. 148 of Indian Contract Act. a bailment is the *delivery of goods by one person to another for some purpose, upon a contract, that they shall, when the purpose is accomplished, be returned or otherwise deposited off according to the directions of the person delivering them.* In other words, when customer leaves with the banker some valuables for safe custody in the safe deposit vaults or lockers, the banker performs the functions of the bailee and the relationship between the

banker and the customer in such a case is that of a bailee and the bailor.

**5. Banker as a Trustee :** A trust is a relation between two persons by virtue of which one of them (called *trustee*) holds property vested in him for the benefit of the other (called *beneficiary*). For example, if a customer deposits securities or other valuables with the banker for safe custody, he acts as a trustee of his customer. The customer continues to be the owner of the valuables deposited with the banker. The legal position of the banker as a trustee differs from that of a debtor of his customer. In the event of bank's liquidation, such trust properties held by the banker are not available for the distribution to general creditors of the bank.

**6. Proper place and time of demand :** The demand by the creditor (i.e., depositor) must be made at the proper place and in proper time. A commercial bank has a large number of branches.



His / her demand for withdrawal of amount from the deposited funds must be made at the branch where the account has been opened in his / her name during the business hours.

7. **Not time barred** : The deposits with a bank are not time - barred on the expiry of three years as the case with ordinary debt. The Law of Limitation Act does not apply to a banking debt.

8. **Bank as an executor** : Where a customer appoints a banker as his executor and leaves property through a will, the banker has to administer the property according to the terms of the will after the death of such customer. Where no will is written by the deceased, the court may appoint the banker as administrator. In such a case the banker has to distribute the property of the deceased according to the suggestion laws applicable.

9. **Banker as an Attorney** : The customer may grant a special power of attorney to

his banker to transact certain dealings on his behalf. The banker is the attorney of the customer in such cases.

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A customer is one who has an account with a bank. To comprise a customer, there must be some recognizable course of habit of dealing in the nature of regular banking business.

**Types of Customers in Bank:**

The below given persons can be the customer of a bank.

- Minors
  - Illiterates
  - Married women
  - Lunatics
  - Trustees
  - Joint account holders
  - Executors and administrators
  - Power of attorney holders
  - Proprietorships
  - Hindu undivided families
  - Partnerships
  - Limited companies
  - Clubs, Societies and charitable institutions
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- They may also be non-residents and foreigners.

## **Minors**

A minor is someone who is under the age of 18. If a minor has a guardian appointed by the court he/ she will remain as a minor till the age of 21.

### **Hindu minors**

If the minor is a Hindu, the natural guardian is the father and then the mother. This does not include stepfathers/ stepmothers. With regard to a minor married girl, her husband will be the natural guardian. If the father becomes a Sanyasi (Hindu holy man) or does not remain a Hindu he will not remain as a guardian. A Hindu father can appoint a guardian; such a guardian will act after the death of the parents. The court can appoint a guardian if, in the opinion of court, the father is unfit to be a guardian.

The Supreme Court has held that a mother can act as the natural guardian if the father is not in actual charge of the affairs of the minor because of his unresponsiveness or because of an agreement with the mother.

The Reserve Bank of India has advised banks to permit the opening of minor's accounts (fixed, saving and recurring deposit accounts) with the mother as the guardian even if the father of the minor is alive. The Supreme Court in *Githa Hariharan & another* held that "and after him" does not mean after the death of the father but refers to the father's absence from the concern of the minor's property. Banks must have in place safeguards to make sure that the accounts are never overdrawn and always remain in credit.

### **Muslim minors**

In the case of Muslim minors only fathers can act as a guardian, mothers cannot sign as guardians. If a minor dies, the guardian can withdraw the balance in the account. If it is a joint account the balance will be at the complete disposal of the guardian. If the guardian dies the balance will be paid to the minor after maturity or to the natural guardian.

There is no risk in opening an account in the name of a minor, but it should not be overdrawn. Bankers cannot recover money due if there is a loan or an overdraft as it is *ab initio* invalid. If a minor has pledged assets for getting a loan, the banker cannot possess these assets because the pledge with minor is invalid. If an advance is granted to a minor on the guarantee of a third party, this advance cannot be recovered from the guarantor also as the contract between the banker and the principal debtor minor is invalid. A minor can draw, negotiate or endorse cheques and bills but cannot be held liable or sued if these are not honored.

A minor can be admitted to a partnership with the permission of the other partners but he will not be liable for losses. He must deny his liability as a partner within 6 months of becoming a major. Otherwise he can be held liable for the debts of the partnership. A minor can also be an agent but he may not be held responsible to his principal.

### **Married Women**

A married woman can enter into a valid contract; she can also open a bank account. The husband will not be liable with regard to debts taken unless the loan is taken with his consent and authority or it is for the necessities of life.

## **Illiterate Persons**

Bank accounts can be opened in the name illiterate persons. As they cannot sign their thumb impressions are usually considered so. It should be attested by a person known to the bank. Normally illiterate persons are not given with cheque books. To withdraw money the account holder is expected to come in person to the bank and affix his thumb impression in the presence of a bank official for identification. There is no legal bar in two illiterate persons opening a joint account.

The account opening forms should have a clause wherein it is stated that the terms of account opening and banking has been explained to the account holder. The account holder should affix his thumbprint in the presence of a witness/ official.

## **Lunatics**

Lunatics and persons of unsound mind are not capable of entering into a valid contract. Accounts should not be opened in the name of persons of unsound mind, if a banker has discounted a bill written, endorsed or accepted by a person of unsound mind, the banker can realize the money only if he can prove that he was unaware of the lunacy of the other person. All transactions in the account of a person declared to be of unsound mind must be stopped when a banker receives notice that an account holder is of unsound mind.

If an account holder becomes a person of unsound mind, he should not be permitted to handle his account.

## **Trustee**

A trustee is a person on whom confidence is rested. Trusts are formed by a document called trust deed. Bankers should scrutinize the trust deed thoroughly and determine the powers vested in the trustees. Trustees are generally expected to act jointly; they are not permitted to delegate their powers to others unless the trust deed permits them to do so.

## **Cancellation of power of attorney**

A power of attorney can be cancelled in the following ways :

- When the principal cancels the power of attorney
- When the purpose for which it has been given ends.
- If the principal dies
- If the principal loses the ability to enter into a contract

## **Joint Account holders**

A joint account should be in the name of more than one person. The application for the joint account should be signed by all the persons opening the account. Banks must examine every request to open joint accounts carefully, in particular the purpose, the nature of business and the financial status of the account holders. Clear instructions must be obtained regarding the manner of operation which may be. Following are the ways in which the operations can be done :

- By all the depositors jointly
- By either or survivor
- By former or survivor
- By the depositor jointly or by the survivor.

It should be clearly stated that who may operate the account and state their authority. If this is not given then only cheques signed by all the persons in whose name the account stands should be honored. A joint account holder who is allowed to operate the account cannot by himself appoint an agent to operate the account.