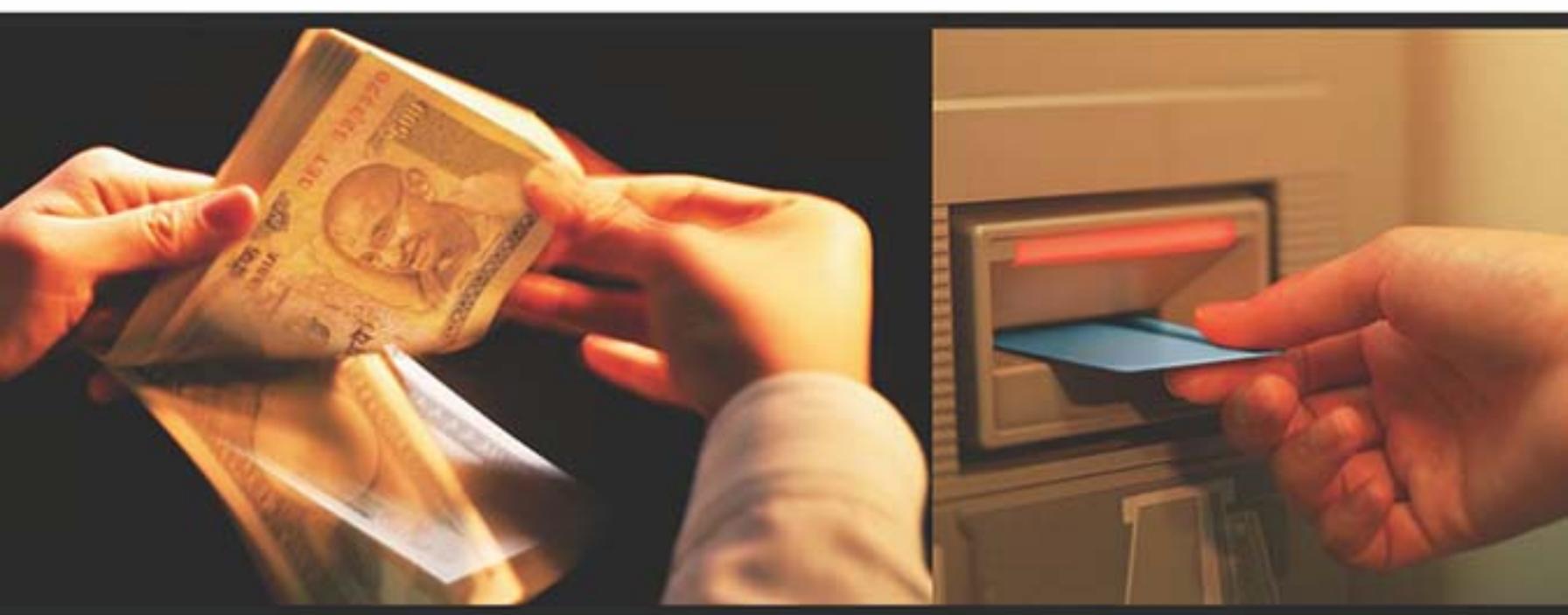




21<sup>st</sup> Edition

# BANKING

## THEORY AND PRACTICE



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# 1

## EVOLUTION OF BANKING INSTITUTIONS



### LEARNING OBJECTIVES

*After reading this chapter, a student should be able to get an insight into:*

- Evolution of the banking system
- Growth of private banking and establishment of the Bank of England
- Various aspects of modern banking

### INTRODUCTION

It may be said that banking, in its most simple form, is as old as authentic history. As early as 2000 BC Babylonians had developed a system of banks. In ancient Greece and Rome, the practice of granting credit was widely prevalent. 'Traces of credit by compensation and by transfer orders are found in Assyria, Phoenicia and Egypt before the system attained full development in Greece and Rome. The books of the old Sanskrit law giver, Manu, are full of regulations governing credit. He speaks of judicial proceedings in which credit instruments were called for, interest of loans on bankers, usurers, and even of the renewal of commercial papers.'<sup>1</sup>

In Rome, bankers were called *Argentarii*, *Mensarii* or *Callybistoe*. The banks were called *Tabernae Argentarioe*. Some of the banks carried business on their own account and others were appointed by the government to receive taxes. They used to transact their business on similar lines as those of modern banks. People used to settle their accounts with their creditors by giving a cheque or draft on the bank. If the creditor also had an account at the same bank, the account was settled by an order to make the transfer of such money from one name to another. To pay money by a draft was known as *prescribere* and *rescribere* and the draft was

<sup>1</sup> Macleod: *Theory of Credit*.

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known as *attributio*. These bankers also received deposits and lent money. Loan banks were also common in Rome. From these loan banks, the poor citizens received loans without paying interest. They lent money for a period of three or four years on the security of land.

During the early periods, though the banking business was done by private individuals, many countries established public banks either for the purpose of facilitating commerce or to serve the Government. The Bank of Venice, established in 1157, is supposed to be the most ancient bank. Originally, it was not a bank in the modern sense, being simply an office for the transfer of the public debt.

History shows the existence of a *Monte* in Florence in 1336. The meaning of *Monte* is given in the Italian dictionary, 1959, as '*Monte* – a standing bank or mount of money, as they have in diverse cities of Italy.' Banbrigge, an English writer, speaks about the 'three bankers of Venice' meaning the three public loans or *Monte*.

As early as 1349, the business of banking was carried on by the drapers of Barcelona. There it was subject to official regulation. The drapers were not allowed to commence this business until they had given sufficient security. During 1401, a public bank was established in Barcelona. It used to exchange money, receive deposits and discount bills of exchange both for the citizens and for the foreigners. The Bank of Amsterdam was established in 1609 to meet the needs of the merchants of the city. It accepted all kinds of specie on deposits. These deposits could be withdrawn on demand or transferred from the account of one person to another. The bank also adopted a plan by which a depositor received a kind of certificate entitling him to withdraw his deposit within six months. These written orders, in course of time, came to be used in the same manner as modern cheques. It is interesting to note that most of the European banks in existence were formed on the model of the Bank of Amsterdam.

The beginning of English banking may correctly be attributed to the London Goldsmiths. They used to receive their customers' valuables and funds for safe custody and issue receipts acknowledging the same. These notes, in course of time, became payable to bearer on demand, hence enjoying considerable circulation. In fact, the goldsmiths' note may be considered as the precursor of the bank note. The business of the goldsmiths got a rude shock by the ill-treatment of the Government of Charles II under the Cabal ministry. In the words of Bagehot, 'It had perpetrated one of those monstrous frauds which are likewise gross blunders. The goldsmiths, who then carried upon a trifling scale what we should now call banking, used to deposit their reserve of treasure in the 'Exchequer' with the sanction and under the care of the Government... . But Charles II showed that it was trusted undeservedly. He shut up the 'Exchequer', would pay no one, and so the goldsmiths were ruined.'

However, the ruin of goldsmiths mark a turning point in the history of English banking which resulted in the growth of private banking and the establishment of the 'Bank of England' in 1694.

In India, as early as the Vedic period, banking existed in the crudest form. The books of Manu contain references regarding deposits, pledges, policy of loans and rates of interest. Banking in those days, largely meant moneylending, and the complicated mechanism of modern banking was not known to them.

This is true not only in the case of India but also of other countries. Although the business of banking is as old as authentic history, banking institutions have since then changed in character and content very much. They have developed from a few simple operations involving the satisfaction of a few individuals' wants to the complicated mechanism of modern banking, involving the satisfaction of the whole community by securing

speedy application of capital seeking employment and providing the very life blood of commerce.

SUMMARY

The system of banks was started by Babylonians before 2000 BC

As early as 1349, the business of banking was carried on by the drapers of Barcelona. In Rome, bankers were called *Arjentarii*, *Mensarii* or *Callybistoe* and banks were called *Tabernae Argentarioe*. Payment of money by a draft was known as *prescribere* and *rescribere* whereas a draft was known as *attributio*. According to the Italian dictionary, *Monte* means a standing bank or mount of money.

The origin of English banking may be traced to the business of London goldsmiths. In 1694, the growth of private banking and establishment of the Bank of England led to the ruin of goldsmiths.

The books of Manu, the Sanskrit law giver, contain references to deposits, pledges, policy of loans and rates of interest.

**PART I**

**COMMERCIAL BANKING THEORY**

# 2

## COMMERCIAL BANKING



### LEARNING OBJECTIVES

*After reading this chapter, a student should be able to get an insight into:*

- Functions of commercial banks and the services rendered by them
- General structure and methods of commercial banks
- Mechanism of credit creation by commercial banks
- The clearing house system
- Systems of banking such as unit banking, branch banking, holding company banking and chain banking
- Investment banking and mixed banking
- Universal banking
- Merchant banking
- Virtual banking
- Green banking

### INTRODUCTION

Commercial banks are organized on a joint stock company system, primarily for the purpose of earning a profit. They can be either of the branch banking type, as seen in most of the countries, with a large network of branches, or of the unit banking type, as seen mainly in the USA, where a bank's operations are confined to a single office or to a few branches within a strictly limited area. Although, the commercial banks attract deposits of all kinds—current, savings and fixed—their resources are chiefly drawn from current deposits which are repayable on demand. So, they attach much importance to the liquidity of their investments and as such they specialize in satisfying the short-term credit needs of business rather than the long-term.

## FUNCTIONS OF COMMERCIAL BANKS AND THE SERVICES RENDERED BY THEM

The two essential functions of a commercial bank may best be summarized as the borrowing and the lending of money. They borrow money by taking all kinds of deposits. Deposits may be received on current account whereby the banker incurs the obligation to repay the money on demand. Interest is not payable on current account deposits. When deposits are received on savings bank account as well, the bank undertakes the obligation to repay them on demand. Interest is usually allowed on savings bank deposits although there are usually restrictions on the total amount that can be withdrawn and/or the number of times withdrawals are allowed during a defined period. When deposits are received on fixed deposit accounts, the banker incurs the obligation to repay the money together with an agreed rate of interest after the expiry of a fixed period. When deposits are received on deposit accounts, the banker undertakes to repay the customer together with an agreed rate of interest in return for the right to demand from him an agreed period of notice for withdrawals. In addition, a new banking account, which is similar to savings bank account, known as *flexi bank account* has been introduced by banks.<sup>1</sup> Thus, a commercial bank mobilizes the savings of the society. This money is then provided to those who are in need of it by granting overdrafts or fixed loans or by discounting bills of exchange or promissory notes. In short, the primary function of a commercial bank is that of a broker and a dealer in money. By discharging this function efficiently and effectively, a commercial bank renders a very valuable service to the community by increasing the productive capacity of the country and thereby accelerating the pace of economic development. It gathers the small savings of the people, thus reducing the quantity of idle money to the lowest limits. Then, it combines these small holdings in amounts large enough to be profitably employed in those enterprises where they are most called for and most needed. Here it makes capital effective and gives industry the benefits of capital, both of which otherwise would have remained idle. For instance, take the practice of discounting bills of exchange. By converting future claims into present money, the commercial bank bridges the time element between the sale and the actual payment of money. This will enable the seller to carry on his business without any hindrance; and the buyer will get enough time to realize the money.

Thus, a commercial bank receives deposits which it has to repay according to its promise and makes them available to those who are really in need of them. The bank is actually distributing its deposits between the borrowers and its own vaults. Herein, lies the most delicate of the functions of a commercial bank.

Besides these two main functions, a commercial bank performs a variety of other functions which may broadly be grouped under two main heads, viz., the agency services and the general utility services.

### **Agency Services**

A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank and paid directly into their bank accounts, or for the bank to detach coupons from bearer bonds and present them for payment and to act upon announcements in the press of drawn bonds, coupons payable, etc. Orders for the purchase or sale of stock exchange securities are executed through the banks' brokers who will also give their opinions on securities

<sup>1</sup> More on this type of account is given in the chapter 'Indian Joint-Stock Banks'. The reader's attention is invited to that chapter.

or lists of securities. Similarly, banks will make applications on behalf of their customers for allotments arising from new capital issues, pay calls as they fall due and ultimately obtain share certificates or other documents of title. On certain agreed terms, the banks will allow their names to appear on approved prospectuses or other documents as bankers for the issue of new capital; they will receive applications and carry out other instructions.

A commercial bank undertakes the payment of subscriptions, premia, rent, etc., on behalf of its customers. Similarly, it collects cheques, bills of exchange, promissory notes, etc., on behalf of its customers. It also acts as a correspondent or representative of its customers, other banks and financial corporations.

Most of the commercial banks have an 'Executor and Trustee Department'. Some may have affiliated companies to deal with this branch of business. They aim to provide a complete range of trustee, executor or advisory services for a small charge. The business of banks acting as trustees, executors, administrators, etc., has continuously expanded with considerable usefulness to their customers. By appointing a bank as an executor or trustee of his/her will, the customer secures the advantage of continuity, avoiding to have made changes, impartiality in dealing with beneficiaries and in the exercise of discretions and the legal and specialized knowledge pertaining to executor and trustee services. When a person dies without making a will, the next-of-kin can employ the bank to act as administrator and to deal with the estate in accordance with the rules relating to intestacies. Alternatively, if a testator makes a will but fails to appoint an executor, or if an executor is unable or unwilling to act, the bank can usually undertake the administration with the consent of the persons who are immediately concerned. Banks will act solely or jointly with others in these matters, as also in the case of trustee for stocks, shares, funds, properties or other investments. Under a declaration of trust, a bank undertakes the supervision of investments and distribution of income; a customer's investments can be transferred into the bank's name or control, thus enabling it to act immediately upon a notice of rights issue, allotment letters, etc. Alternatively, where it is not desired to appoint the bank as nominee, these services may still be carried out by appointing the bank as attorney. Where business is included in an estate or trust, a bank will provide for its management for a limited period, pending its sale to the best advantage as a going concern or transfer to a beneficiary.

Private companies wishing to set up pension funds may appoint a bank as custodian, trustee and investment advisor, while retaining the administration of the scheme in the hands of the management of the fund.

Most banks will undertake the preparation of income tax returns on behalf of their customers and claim for the recovery of overpaid tax. They also assist the customers in checking the assessments. In addition to the usual claims involving personal allowances and reliefs, claims are prepared on behalf of residents abroad, minors, charities, etc.

### **General Utility Services**

These services are those in which the bank's position is not that of an agent for his customer. They include the issue of credit instruments like letters of credit and travellers' cheques, the acceptance of bills of exchange, the safe custody of valuables and documents, the transaction of foreign exchange business, acting as a referee as to the respectability and financial standing of customers, providing specialized advisory service to customers, etc.

### **Banker's Drafts and Letters of Credit**

By selling drafts or orders and by issuing letters of credit, circular notes, travellers' cheques, etc., a commercial bank is discharging a very important function. A banker's draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to

pay a specified sum to the person concerned. A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document, to the extent of a stated amount in the letter and charge the same to the account of the grantor of the letter of credit. A letter of credit includes a promise by the issuing banker to accept all bills of exchange to the limit of credit. When the promise to accept is conditional on the receipt of documents of title to goods, it is called a 'documentary letter of credit'. When the promise is unconditional, it is called a 'clean letter of credit'. Letters of credit may again be classified as revocable and irrevocable. A 'revocable letter of credit' is one which can be cancelled at any time by the issuing banker. But the banker will still be liable for bills negotiated before cancellation. An 'irrevocable letter of credit' is one which cannot be cancelled before the expiry of the period of its currency. 'Circular letters of credit' are generally intended for travellers who may require money in different countries. They may be divided into 'travellers letter of credit' and 'guarantee letters of credit'. A 'travellers letter of credit' carries the instruction of the issuing bank to its foreign agents to honour the beneficiary's drafts, cheques, etc., to a stated amount which it undertakes to meet on presentation. While issuing a 'guarantee letter of credit', the bank secures a guarantee for reimbursement at an agreed rate of interest, or it may insist on sufficient security for the grant of credit. There is yet another type which is known as 'revolving credit'. Here the letter is so worded that the amount of credit available automatically reverts to the original amount after the bills negotiated under them are duly honoured.

### ***Circular Notes, Travellers Cheques, Circular Cheques***

Circular notes are cheques on the issuing banker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the name of the holder and referring to a letter of indication in his hands, containing the specimen signature of the holder. The note will not be honoured unless the letter of indication is presented. Travellers' cheques are documents similar to circular notes with the exception that they are not accompanied by any letter of indication. Circular cheques are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

### ***Safe Custody of Valuables***

Another important service rendered by a modern commercial bank is that of keeping in safe custody valuables such as negotiable securities, jewellery, documents of title, wills, deed-boxes, etc. Some branches are also equipped with specially constructed strong rooms, each containing a large number of private steel safes of various sizes. These may be used for a small fee. Each user is provided with the key of an individual safe and thus not only obtains protection of his/her valuables but also retains full personal control over them. The safes are accessible at any time during banking hours, and often longer.

### ***Night Safes***

For shopkeepers and other customers who handle large sums of money after banking hours, 'night safes' are available at many banks. Night safe takes the form of a small metal door on the outside wall of the bank, accessible from the street, behind which there is a chute connecting with the bank's strong room. Customers who require this service are provided with a leather wallet, which they lock before placing in the chute. The wallet is opened by the customer when he calls at the bank the next day to get the contents credited to his account.

### ***Referee as to the Respectability and Financial Status of the Customer***

Another function of great value, both to banks and businessmen, is that of the bank acting as a referee as to the respectability and financial status of the customer.

### ***Bank Giro***

Among the services introduced by a modern commercial bank during the last quarter of a century or so, the 'bank giro' and 'credit cards' deserve special mention. The 'bank giro' is a system by which a bank customer with many payments to make, instead of drawing a cheque for each item, may simply instruct his bank to transfer to the bank accounts of his creditors the amount due from him. He writes one cheque debiting his account with the total amount. Credit advices containing the name of each creditor with the name of his bank and branch will be cleared through the 'credit clearing' of the clearing house, which operates in a similar way as for the clearing of cheques. Even non-customers of a bank may make use of this facility for a small charge. A direct debiting service is also operated by some banks. This service is designed to assist organizations which receive large number of payments on a regular basis. A creditor is thereby enabled, with the prior approval of the debtor, to claim any money due to him direct from the debtor's bank account. To some organizations, for example, insurance companies, which receive, say, six equal sums on six dates in a year, the scheme is only an extension of the standing order facility but for the public utilities and traders which send out invoices for valuable amounts at differing times, the scheme is an entirely new one.

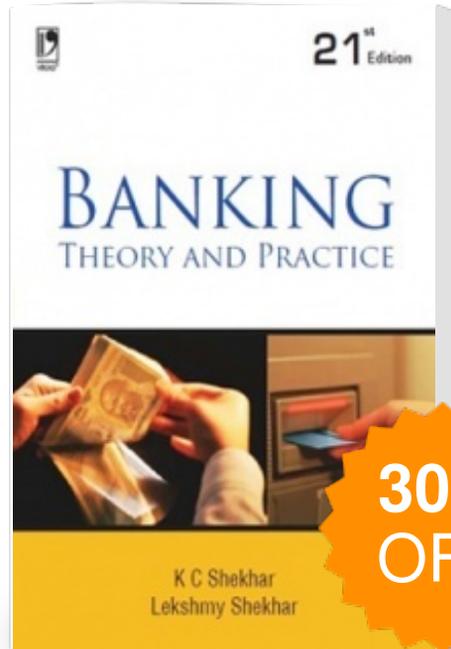
### ***Credit Cards***

A credit card is basically a payment mechanism which allows the holder of the card to make purchases without any immediate cash payment. Credit limit is fixed by the issuing bank and the limit is determined by the financial history as well as the type of card. Users are issued with a card on production of which their signatures are accepted on invoices in merchant establishments participating in the scheme. The issuing bank makes the payment to the merchant establishment selling the relevant goods or services. The holder to whom the card is issued, in turn, reimburses the bank on receipt of the billing statement. Generally it is not necessary to reimburse the bank with the entire amount on the billing statement. After making payment of the minimum amount due every month, the balance could be staggered over a period. Of course, outstanding balance plus any overdue will attract service charge at a certain rate. Also, users are generally required to pay a regular subscription for the use of the service. Different types of cards are available. The benefits attached to the card vary according to the type of the card.

Often, the bank which issues the card will be a member of a payments brand. For instance, VISA is a payments brand with global payments system. Its cards are accepted at numerous locations (about 23 million merchant establishments) all over the world. All establishments displaying VISA logo accept VISA cards for all transactions. Of course, VISA itself does not offer cards or financial services; it only advances new payment products and technologies on behalf of its members.

On every card transaction conducted, the merchant establishment will give a commission which will be shared by the issuing bank and the acquirer bank (i.e., the bank which approaches the merchant establishment for its acceptance of the card). If it is a branded card, a part of the commission will go to the payments brand. For instance, if it is a VISA card, a part of the commission will go to VISA. Suppose Bank 'A' has convinced merchant establishment 'X' to accept VISA cards. This means that all VISA cards will be accepted by establishment 'X'. In

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