COURSE GUIDE

BFN 301
PRACTICE OF BANKING

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CONTENT **PAGE**

INTRODUCTION

BFN 301: Practice of Banking is a three credit course for students offering B.Sc. Banking and Finance in the School of Management Sciences. The course consists of eighteen (18) units, that is, three (3) modules of six (6) units for each module. The material has been developed to suit undergraduate students in Banking and Finance at the National Open University of Nigeria (NOUN) by using an approach that analyzes practice of banking. A student who successfully completes the course will surely be in a better position to handle the intricacies of practical banking operations.

The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through these materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully. It also gives you some guidance on your tutor-marked assignments. Detailed information on tutor-marked assignment is found in the separate assignment file which will be available in due course.

WHAT YOU WILL LEARN IN THIS COURSE

This course will introduce you to some fundamental aspects of financial systems generally. It also includes: Banking Operations in Nigeria; Types of Banking Operations in Nigeria; Banker and Customer Relationship; Accounts of Customers; Specialize Bank Accounts of Customers; Negotiable Instruments; Duties of Paying Banker and Collecting Banker; Other Services offered by Banks; Relationships with Limited Liabilities Companies: Loans and Advances; Bankruptcy; Securities for Bankers Advances; Securities and Loan Recovery; Land and Security; Life Policies and Shares as Collaterals; Shares Guarantees; Debentures; Other Forms of Securities; and Guarantees for Loans and Advances

COURSE AIMS

The course aims, among others, are to give you understanding of the intricacies of financial systems and how to apply such knowledge in managing financial institutions and their operations. The course will help you to appreciate types of banks in operations in the country, models of commercial banking after the abolition of universal banking in the country, relationships between customers and the banks and forms of collateral securities that can be accepted by banks for loans and advances, among others topics.

The aims of the course will be achieved by:

(i) Discussing Banking Operations in Nigeria;
(ii) Mentioning and Explaining Types of Banking Operations in Nigeria;
(iii) Explaining Banker and Customer relationship;
(iv) Identifying and Discussing Accounts of Customers;
(v) Mentioning and Explaining Specialize Accounts of Customers;
(vi) Listing and Discussing Negotiable Instruments;
(vii) Listing the Duties of Paying and Collecting Bankers;
(viii) Mentioning and explaining Other Services of Banks;
(ix) Discussing Relationships with Limited Liability Companies in relations to Loans and Advances;
(x) Discussing Bankruptcy;
(xi) Mentioning and Discussing Securities for Bank Advances;
(xii) Discussing Securities and Loan Recovery;
(xiii) Discussing Land and Security;
(xiv) Explaining Life Policies and Shares as Collaterals;
(xv) Discussing Shares Guarantees;
(xvi) Explaining Debentures;
(xvii) Mentioning and Discussing Other Forms of Securities; and
(xviii) Discussing Guarantees for Loans and Advances.

COURSE OBJECTIVES

By the end of this course, you should be able to:

(i) Discuss Banking Operations in Nigeria;
(ii) Mention and Explain Types of Banking Operations in Nigeria;
(iii) Explain Banker and Customer relationship;
(iv) Identify and Discuss Accounts of Customers;
(v) Mention and Explain Specialize Accounts of Customers;
(vi) List and Discuss Negotiable Instruments;
(vii) List the Duties of Paying and Collecting Bankers;
(viii) Mention and explain Other Services of Banks;
(ix) Discuss Relationships with Limited Liability Companies in relations to Loans and Advances;
(x) Discuss Bankruptcy;
(xi) Mention and Discuss Securities for Bank Advances;
(xii) Discuss Securities and Loan Recovery;
(xiii) Discuss Land and Security;
(xiv) Explain Life Policies and Shares as Collaterals;
(xv) Discuss Shares Guarantees;
(xvi) Explain Debentures;
(xvii) Mention and Discuss Other Forms of Securities; and
(xviii) Discuss Guarantees for Loans and Advances.

WORKING THROUGH THIS COURSE

To complete this course, you are required to read all study units, attempt all the tutor marked assignments and study the principles and practice of lending and credit administration in this material provided by the National Open University of Nigeria (NOUN). You will also need to undertake practical exercises for which you need access to a personal computer. Each unit contains self-assessment exercises, and at certain points during the course, you will be expected to submit assignments. At the end of the course is a final examination. The course should take you about a total of 17 weeks to complete. Below are the components of the course, what you have to do, and how you should allocate your time to each unit in order to complete the course successfully on time.

COURSE MATERIALS

Major components of the course are:

(i) Course Guide
(ii) Study Units
(iii) Textbooks
(iv) Assignment file

STUDY UNITS

The study units in this course are as follows:

Module 1

Unit 1: Banking Operations in Nigeria
Unit 2: Types of Banking Operations in Nigeria
Unit 3: Banker and Customer Relationship
Unit 4: Accounts of Customers
Unit 5: Specialize Bank Accounts of Customers
Unit 6: Negotiable Instruments and Cheques

Module 2

Unit 1: Bills of Exchange and Promissory Notes
Unit 2: Duties of Paying Banker and Collecting Banker
Unit 3: Bank Lending to Limited Liabilities Companies
Unit 4: Securities and Loan Recovery
Unit 5: Securities for Bankers Advances
Unit 6: Land and Security

Module 3

Unit 1: Shares as Collateral Securities for Bank Advances
Unit 2: Negotiable and Non-negotiable Securities
Unit 3: Mortgage and Debentures
Unit 4: Produce and Goods as Securities
Unit 5: Guarantees for Loans and Advances
Unit 6: Bankruptcy

ASSIGNMENT FILE

In this course, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain for these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in the section on assessment in this course guide. There are 18 tutor-marked assignments in this course; which you are expected to attempt all of them.

PRESENTATION SCHEDULE

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marked assignments (TMAs) and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against falling behind in your work.

ASSESSMENTS

There are two aspects to the assessment of the course: first is the tutor-marked assignments; and second is a written examination. In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the **Presentation Schedule** and the **Assignment File**. The work you submit to your tutor will count for 30% of your total course mark. At the end of the course, you will need to sit for a final written examination of ‘three hours’ duration. This examination will also count for 70% of your total course mark.

TUTOR-MARKED ASSIGNMENT (TMAs)

There are fifteen tutor-marked assignments in this course and you are advised to attempt all. Aside from the course material provided, you are advised to read and research widely using other references (under further reading) which will give you a broader viewpoint and may

provide a deeper understanding of the subject. Ensure all completed assignments are submitted on schedule before set deadlines. If for any reasons, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Unless in exceptional circumstances, extensions may not be granted after the due date for the submission of the assignments.

FINAL EXAMINATION AND GRADING

The final examination for this course will be of three-hour duration and have a value of 70% of the total course grade. All areas of the course will be assessed and the examination will consist of questions, which reflect the type of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed. Utilise the time between the conclusion of the last study unit and sitting for the examination to revise the entire course. You may find it useful to review your self-assessment tests, tutor-marked assignments and comments on them before the examination.

COURSE MARKING SCHEME

The work you submit will count for 30% of your total course mark. At the end of the course, you will be required to sit for a final examination, which will also count for 70% of your total mark. The table below shows how the actual course marking is broken down.

ASSESSMENT MARKS

Assignments (TMAs): 4 assignments, best 3 will be used for the Continuous Assessment, which will constitute a total of 30%. Final Examination of 70% for overall course marks. **Total of Continuous Assessment and Final Examination is 100% for the Course.**

14.0 ASSIGNMENT FILE

Table 1: Guide on Assignment Activity

Unit	Unit Title of work	Week's activity Assessment
1	Banking Operations in Nigeria	1
2	Types of Banking Operations in Nigeria	1
3	Bank and Customer Relationship	1
4	Accounts of Customers	1
5	Specialize Accounts of Customers	1
6	Negotiable Instruments and Cheques	1
7	Bills of Exchange and Promissory Notes	1

8	Duties of Paying Bankers and Collecting Bankers	1
9	Bank Lending to Limited Liabilities Companies	1
10	Securities and Loan Recovery	1
11	Securities for Bankers Advances	1
12	Land and Security	1
13	Shares as Collateral Securities for Bank Advances	1
14	Shares Guarantees	1
15	Debentures	1
16	Produce and Goods as Securities	1
17	Guarantees for Loans and Advances	1
18	Bankruptcy	1
	Revision Total	**18**

TUTORS AND TUTORIALS

There are 15 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone numbers of your tutor, as soon as you are allocated a tutorial group. Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion group if you need help.

The following might be circumstances in which you would find help necessary, when you:

- do not understand any part of the study units or the assigned readings.
- have difficulty with the self-tests or exercises.
- have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly.

You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list

before attending them. You will learn a lot from participations in discussions.

SUMMARY

BFN 30: Practice of Banking intends to expose the undergraduate students to the fundamentals of banking practices, bank and customer relationships, accounts of customers, services of various types of banks, and securities being accepted for loans and advances. Upon completing the course, you will be equipped with the necessary knowledge of banking system required to produce a good research work in banking and finance. We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the future.

MAIN COURSE

CONTENT **PAGE**

MODULE 1

UNIT 1 BANKING OPERATIONS IN NIGERIA

CONTENTS

1.0 INTRODUCTION

The Nigerian economy like any other country around the world is fraught with operations of various financial institutions and the most influential ones are the various banking institutions. This is because of their strategic role in financial intermediation side other peculiar functions which they render to the growth and development of the economy. In this initial study unit of the material, we shall discuss banking institutions in the Nigerian economy.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the historical development of commercial banks in Nigeria
- trace the development of the Central Bank of Nigeria
- discuss the operational position of banks in the economy
- discuss the recent consolidation in the banking industry.

3.0 MAIN CONTENT

3.1 Inception of Commercial Banking System in Nigerian Economy

In 1892 the African Banking Corporation as Nigeria's first bank was established. Banking legislation never existed until 1952, at which point Nigeria had three foreign banks such as the British Bank for West Africa (BBWA), Barclays Bank, and the British and French Bank and two indigenous banks, the National Bank of Nigeria and the African Continental Bank with a collective total of forty branches.

A Banking Ordinance of 1952 was used to establish standards, required reserve funds, established bank examinations, and provided for assistance to indigenous banks.
The British colonial officials brought the West African Currency Board into the banking scene in 1912. The Board was established to enhance financing the export trade of foreign firms in the West African sub-region in addition to the issuance of a West African currency convertible to British pounds sterling. However, the colonial masters introduced discriminating measures against the growth of financial transactions in the country. These policies barred local investment of reserves, discouraged deposit expansion, precluded discretion for monetary management, and lack of deliberate measures to train Nigerians in developing indigenous financial institutions.

In 1952 several Nigerian members of the Federal House of Assembly called for the establishment of a central bank to facilitate economic development. In spite of the fact that the motion was defeated, the colonial administration appointed a Bank of England official to study the issue. As expected the official so appointed advised against a central bank, hinging it on his doubt whether such a bank can be effective in an undeveloped capital market such as was the case in the country's economy. In 1957 the Colonial Office sponsored another study that paved the way for the establishment of a Nigerian central bank.

In the same year (1957), the Colonial Office introduced a Nigerian currency, the Nigerian pound which value was pegged at par with the pound sterling until the British currency was devaluation in 1967. The Nigerian pound was converted in 1973 to a decimal currency, the Naira (N), equivalent to two old Nigerian pounds. The smallest unit of the new currency was the kobo, 100 of which was equaled 1 Naira. The naira, which exchanged for US$1.52 in January 1973 and again in March 1982 (or N0.67 = US$1), despite the floating exchange rate, depreciated relative to the United States dollar in the 1980s. The average exchange rate in 1990 was N8.004 = US$1. Nevertheless, depreciation of the

Naira accelerated after the introduction of the World Bank induced Structural Adjustment Programme (SAP), which resulted in the inception of a second-tier foreign exchange market in the Nigerian economy in September 1986.

SELF-ASSESSMENT EXERCISE 1

Discuss briefly the evolution of banking in Nigeria.

3.2 Establishment of Central Banking in Nigeria

The Central Bank of Nigeria (CBN), which was established in 1957 as a statutorily banking institution independent of the federal government until 1968, began operations on July 1, 1959. The struggle over the relationship between the government and the Central Bank lasted for a decade until a 1968 military decree granted authority over banking and monetary policy to the Federal Executive Council.

The role of the Central Bank, which was similar to that of central banks in North America and Western Europe, hinged around operations such as to:

i) establish the Nigerian currency;
ii) control and regulate the banking system;
iii) serve as banker to other banks in Nigeria;
iv) carry out the government's economic policy in the monetary field.

The intended economic policies to be discharged by the Central Bank of Nigeria included:

a) controlling of bank credit growth;
b) establishing credit distribution by sector;
c) fixing cash reserve requirements for commercial banks;
d) determination of rediscount rates, that is, interest rates the Central Bank charged commercial and merchant banks; and
e) establishing the ratio of banks' long-term assets to deposits.

It is instructive to note that any changes in Central Bank restrictions on credit and monetary expansion affected total demand and income in the economy. For example, in 1988, as inflation accelerated, the Central Bank tried to restrain monetary growth.

During the civil war in the country between 1967 and 1970, the government established limits on repatriation of dividends and profits, reduced foreign travel allowances for Nigerian citizens, the size of allowances to overseas public offices, required official permission for all

foreign payments, which were and later suspended. In January 1968, the government issued new currency notes to replace those in circulation. Although in 1970 the Central Bank advised against dismantling of import and financial constraints too soon after the war, the oil boom soon permitted Nigeria to relax restrictions.

In 1997, the Federal Government of Nigeria enacted the CBN (Amendment Decree No. 3 and Banks and other Financial Institutions [BOFI (Amended)] Decree No. 4 in 1997 to remove completely the limited autonomy which the Bank enjoyed in its operations as the apex bank in the banking industry since 1991. The 1997 amendments brought the CBN back under the supervision of the Ministry of Finance. The Decree made CBN directly responsible to the Minister of Finance with respect to the supervision and control of bank and other financial institutions, while extending the supervisory role of the bank to other specialised Banks and Financial Institutions.

The amendment placed enormous powers on the Ministry of Finance while leaving the CBN with a subjugated role in the monitoring of the financial institutions with little room for the Bank to exercise discretionary powers. The current legal framework within which the CBN operates is the CBN (Amendment) Decree No. 37 of 1998 which repealed the CBN (Amended) Decree No. 3 of 1997. The Decree provides a measure of operational autonomy for the CBN to carry out its traditional functions and enhances its versatility.

Furthermore, the regulatory powers of the CBN were strengthened by the Banks and other Financial Institutions (Amendment) Decree No. 38 of 1998 which repealed BOFI (Amendments) Decree No. 4 of 1997. Through the amendments, the CBN may vary or revoke any condition subject to which a license was granted or may impose fresh or additional condition to the granting of a license to transact banking business in the country.

By the Decree, the CBN's powers on banks, specifically those relating to withdrawal of licenses of distressed banks and appointment of liquidators of these banks, including the NDIC was restored. The CBN has also taken responsibility for nurturing the money and capital markets. In furtherance of this, the CBN introduced treasury bills in 1960, treasury certificate in 1968, and facilitated the establishment of Lagos Stock Exchange in 1961 and the capital issue committee now known as the Securities & Exchange Committee in the early 1970s.

SELF-ASSESSMENT EXERCISE 2

Identify the role of the central bank in Nigerian economy.

3.3 Operational Positions of Banks in the Economy

On the basis of available records, the three largest commercial banks (Bank of British West Africa, Barclays Bank, and the British and French Bank) held about one-third of total bank deposits. In 1973 the federal government undertook to acquire a 40-percent equity ownership of the three largest foreign banks. In 1976, under the second Nigerian Enterprises Promotion Decree requiring 60-percent indigenous holdings, the federal government acquired an additional 20-percent holding in the three largest foreign banks and 60-percent ownership in the other foreign banks. Yet indigenization did not change the management, control, and lending orientation toward international trade, particularly of foreign companies and their Nigerian subsidiaries of foreign banks.

At the end of 1988, the banking system in the country consisted of the following

i) Central Bank of Nigeria;
ii) Forty-two (42) commercial banks; and
iii) Twenty four (24) merchant banks,

The above scenario is an indicative of a substantial increase since 1986 at the inception of economic liberalization policy of the then military government. The prevailing economic liberalization policy paved the way for the following:

a) Merchant banks were allowed to open chequeing accounts for corporations only and could not accept deposits below N50,000;
b) Commercial and merchant banks together had 1,500 branches in 1988, up from 1,000 in 1984.

In 1988 commercial banks had assets of N52.2 billion compared to N12.6 billion for merchant banks in early 1988. In the fiscal year 1990 the government expended N503 million into establishing community banks with the intent of encouraging the development of community development associations, cooperative societies, farmers' groups, patriotic unions, and trade groups, among other objectives, particularly in rural areas.

Furthermore, there existed in the economy other banking institutions which were mainly government-owned specialized development banks such as:

i) Nigerian Industrial Development Bank;
ii) Nigerian Bank for Commerce and Industry;
iii) Nigerian Agricultural Bank;

iv) Federal Savings Banks; and
v) Federal Mortgage Bank.

In relation to the development banking regulation, there was an enquiry by the then colonial administration to investigate banking practice in Nigeria. The G. D. Paton Report which emanated from the enquiry formed the basis for the first Banking Ordinance of 1952. The ordinance was designed to ensure orderly commercial banking operations and to prevent the establishment of unviable banks. A draft legislation for the establishment of Central Bank of Nigeria was presented to the House of Representatives in March, 1958. The Act was fully implemented on 1 July, 1959 when the Central Bank of Nigeria came into full operations; at the twilight of the colonial administration.

The Central Bank Act, 1958 (as amended) and the Banking Decree 1969 (as amended) constituted the legal framework within which the CBN operates and regulates banks. The wide range of economic liberalization and deregulation measures following the adoption, in 1986, of a Structural Adjustment Programme (SAP) resulted in the emergence of more banks and other financial intermediaries. Decree 24 and 25 of 1991 were, therefore, enacted to strengthen and extend the powers of CBN to cover the new institutions in order to enhance the effectiveness of monetary policy, regulation and supervision of banks as well as non-banking financial institutions.

SELF-ASSESSMENT EXERCISE 3

Enumerate the specialized banks that existed in the Nigerian Economy in the past.

3.4 Recent Consolidation in the Banking Industry

There was consolidation of commercial banks in 2006, which reduced the number of these banks operating in the country to only 25. The list of such banks is given below (Figure 1.1).

Figure 1.1: Commercial Banks after Consolidation (as at January 1st 2006) in Nigeria

S/n	Name of Bank	S/N	Name of Bank
1)	Access Bank	(14)	Oceanic Bank
2)	Afribank	(15)	Platinum Bank
3)	Diamond Bank	(16)	Skye Bank
4)	EcoBank	(17)	Spring Bank
5)	Equitorial Trust Bank	(18)	Stanbic Bank
6)	First City Monument Bank	(19)	Standard Chartered Bank

7)	Fidelity Bank	(20)	United Bank of Africa
8)	First Bank Plc	(21)	Sterling Bank
9)	First Inland Bank	(22)	Union Bank
10)	Guaranty Trust Bank	(23)	Unity Bank
11)	IBTC-Chartered Bank	(24)	Wema Bank
12)	Intercontinental Bank	(25)	Zenith Bank Plc.
13)	Nigeria International Bank		

Source: Nairaland Forum (2013). The 25 Consolidated Commercial Banks in Nigeria (http://www.nairaland.com/5117/25-consolidated-banks-nigeria).

There was the 2009 banking reform which also reduced the number of commercial banks in the country, as shown below on Figure 1.2.

Figure1.2: List of Commercial Banks after 2009 Reforms in Nigeria	
S/n Name of Bank	S/n Name of Bank
1) Access Bank – (acquired Intercontinental Bank)	(16) Enterprise Bank Limited*
2) Diamond Bank	(formally Spring Bank)
3) ECObank Nigeria – (acquired Oceanic Bank)	(17) Keystone Bank*
4) Fidelity Bank .	(formally Bank PHB)
5) First Bank Plc	(18) Mainstreet Bank Limited*
6) First City Monument Bank – (acquired FinBank)	(formally Afribank)
7) Guaranty Trust Bank	(19) Standard Chartered Bank**
8) IBTC-Chartered Bank	(20) Citi Bank**
9) Standard Chartered Bank	(21) Jaiz Bank (Islamic bank)***
10) Sterling Bank – (acquired Equitorial Trust Bank)	(22) Heritage Bank***
11) Union Bank 12) United Bank of Africa	
13) Unity Bank	
14) Wema Bank	
15) Zenith Bank Plc	

Source: Wikipedia (2013). List of Commercial Banks in Nigeria
*Acquired by CBN after the Reforms in 2009. **Foreign banks in Nigeria. *** Banks established in 2013

The figure above shows that there are only 18 local commercial banks, two foreign banks and one Islamic bank after the 2009 reform in the industry. In addition, there are two merchant banks namely FSDH Merchant bank and Rand Merchant bank operating in the country from January 2013.

4.0 CONCLUSION

The inception of banking institutions in Nigeria is traceable to 1892 when the African Banking Corporation was established. Banking legislation never existed until 1952, at which point Nigeria had three foreign banks such as the Bank of British West Africa, Barclays Bank, and the British and French Bank and two indigenous banks, the National Bank of Nigeria and the African Continental Bank with a collective total of forty branches. In the subsequent developments comes the establishment of the apex bank in the country. In the intervening period before now, many indigenous banks sprang, While some of the first generation banks still exist till today, so many banks came on board only to collapse after some period of time as a result of self-inflicted problems as well as forced consolidation.

5.0 SUMMARY

In this study unit, we discussed banks in Nigeria and in the process analyzed the inception of commercial banking system in Nigerian economy, establishment of central banking in Nigeria, operational position of banks in the economy, and recent consolidation in the banking industry. In the next study unit, we shall discuss types of banking operations in Nigeria.

6.0 TUTOR-MARKED ASSIGNMENT

1. Trace the development of commercial and central banking in Nigeria.
2. Identify the existing commercial banks after the 2009 banking reform in Nigeria.

7.0 REFERENCES AND MATERIALS FOR FURTHER READING

Central Bank of Nigeria (2013). History of the Central Bank of Nigeria, retrieved from http://www.cenbank.org/AboutCBN/history.asp

History of Banking in Nigeria: 1892 – 2010, retrieved from http://www.icr.stakescapital.com/research_int/background/nigerian_banking_industry.html

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UNIT 2 TYPES OF BANKING OPERATIONS IN NIGERIA

CONTENTS

1.0 INTRODUCTION

In the initial study unit of the material, we discussed banking operations in the Nigerian economy. There are various types of banks that operate in any economy and Nigeria is not an exception. Such types include commercial banks which have been categorized into international, national and regional banks, merchant banks that have sprang up after the abolition of the universal banking regime, development banks, mortgage bank, microfinance banks, and in recent time, non-interest

bank which is known as Islamic banking. In this study unit, we shall discuss all these types of banking systems.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss three types of commercial banks in existence in Nigeria
- mention and discuss various types of development banks in operations in Nigeria
- discuss the peculiar functions of merchant banks
- explain the need for the establishment of microfinance banks
- discuss the rationale for the operations of Non-Islamic banking.

3.0 MAIN CONTENT

3.1 Commercial Banks

The CBN banking regulation guideline titled Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010 abolished the universal banking regime and enumerated the following regulations for the commercial banking operations in Nigeria.

A commercial banking license shall confer on an operator of the license, the authority to undertake the following banking business activities and no other:

a. Take deposits and maintain current and saving accounts form.
b. Provide retail banking services, including mortgage products.
c. Provide finance and credit facilities.
d. Deal in foreign exchange and provide foreign exchange services, subject to the requirements of the Foreign Exchange (Monitoring and Miscellaneous Provisions, etc.) Act Cap. F35 Laws of the Federation of Nigeria 2004, any other law and CBN Regulations made pursuant thereto;
e. Act as a settlement bank, subject to CBN approval;
f. Provide treasury management services including but not limited to the provision of money market, fixed income, and foreign exchange investment on behalf of clients, subject to the approval of the CBN;
g. Provide custodial services;
h. Provide financial advisory services incidental to commercial banking business which do not require regulatory filings with the Securities and Exchange Commission such as: advising on financing and business strategies and structures, conducting

research and economic intelligence services, building financial models, writing business plans, conducting private placements, arranging loan syndications and advising on project structures;

i) Invest in non-convertible debt instruments and, subject to CBN approval, enter into derivative transactions;

j) Undertake fixed income trading, where duly licensed to act Undertake fixed income trading, where duly licensed to act as a Primary Dealer/ Market Maker to trade in securities such as Federal Government bonds, treasury bills, treasury certificates and such other debt certificates as may be prescribed by the CBN from time to time;

k) Provide non-interest banking services subject to CBN approval; and

l) Such other activities as may be prescribed in writing by the CBN from time to time.

No commercial bank shall be permitted to carry out the following business activities:

a. Insurance underwriting;
b. Loss adjusting services;
c. Re-insurance services;
d. Asset Management services;
e. Issuing House and Capital Market underwriting services;
f. Investment in equity or hybrid-equity instruments, save and except for the investments permissible under BOFIA;
g. Proprietary trading, save as permitted by these Regulations;
h. Provision of financial advisory other than in accordance with provisions in Section 3(h) and (i) any other business activities that may be restricted by the CBN from time to time

By virtue of the CBN banking regulation guideline titled "Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010" which abolished the universal banking regime, three models of commercial banking operations came into inception such s identified and explained below.

3.1.1 Regional Banking Model

A Commercial Bank with regional banking authorisation shall be entitled to carry on its banking business operations within a minimum of six (6) and a maximum of twelve (12) contiguous States of the Federation, lying within not more than two (2) Geo-Political Zones of the Federation, as well as within the Federal Capital Territory.

A Commercial Bank authorised to conduct business on a regional basis shall as from the date hereof, and as prescribed from time to time by the CBN:

a) Maintain a minimum paid-up share capital of Ten Billion Naira (N10,000,000,000.00) or such other amount as may be prescribed by the CBN from time to time.
b) Comply with all prudential guidelines and regulations issued by the CBN on the required level of capital adequacy, liquidity and cash reserve.
c) Be precluded from carrying out settlement bank activities.
d) Observe all applicable corporate governance standards as may be prescribed by the CBN and other relevant financial service sector regulatory authorities in Nigeria.
e) Design, comply with and implement an internal control framework and reports in accordance with the standard that the CBN may prescribe from time to time;
f) Through its Board of Directors report on the implementation and effectiveness of its internal control framework to the CBN within four months after the end of its financial year;
g) design, comply with and implement a risk management framework which ensures that the Regional Commercial Bank has an appropriate reporting structure, quality, procedure and technology to effectively and adequately identify, measure, monitor and report risks to the CBN, in accordance with any guidelines, circulars or regulations as prescribed by the CBN from time to time.
h) Without prejudice to the standards prescribed from time to time by the Nigerian Accounting Standards Board, be required to maintain its books and financial statements in accordance with the IFRS accounting standards, subject to the provisions of Section 28 of BOFIA.

3.1.2 National Banking Model

A Commercial Bank with national banking authorisation shall be entitled to carry on its banking business operations within every State of the Federation.

A Commercial Bank authorised to conduct business on a national basis shall:

a. Maintain a minimum paid-up share capital of Twenty Five Billion Naira (N25,000,000,000.00) or such other amount as may be prescribed by the CBN from time to time.

b. Comply with all prudential guidelines and regulations issued by the CBN on the required level of capital adequacy, liquidity and cash reserve..
c. Observe all applicable corporate governance standards as prescribed by the CBN and other financial service sector regulatory authorities in Nigeria.
d. Design, comply with and implement an internal control framework and reports in accordance with the standard that the CBN may prescribe from time to time.
e. Through its Board of Directors report on the implementation and effectiveness of its internal control framework to the CBN within four months after the end of its financial year.
f. Design, comply with and implement a risk management framework which ensures that the National Commercial Bank has an appropriate reporting structure, quality, procedure and technology to effectively and adequately identify, measure, monitor and report risks to the CBN, in accordance with any guidelines, circulars or regulations as prescribed by the CBN from time to time.

And without prejudice to the standards prescribed from time to time by the Nigerian Accounting Standards Board, be required to maintain its books and financial statements in accordance with the IFRS accounting standards, subject to the provisions of Section 28 of BOFIA.

The regulation resulted in the inception of the following commercial banks as national banks:

i) Stanbic IBTC Bank Plc;
ii) Standard Chartered Bank Limited;
iii) Sterling Bank Plc;
iv) Unity Bank Plc;
v) Citi Bank Limited;
vi) Afribank Plc; and
vii) Ecobank Nigeria Plc

3.1.3 International Banking Model

A Commercial Bank with international banking authorisation shall be entitled to carry on its banking business operations within all the States of the Federation, as well as to establish and maintain offshore banking operations injurisdictions of its choice, subject to the approval of the CBN and compliance with regulatory requirements of host country.

A Commercial Bank authorised to conduct business on an international basis shall:

a. Maintain a minimum paid-up share capital of Fifty Billion Naira (N50,000,000,000.00) or such other amount as may be prescribed by the CBN from time to time.
b. Comply with all prudential guidelines and regulations issued by the CBN on the required level of capital adequacy, liquidity and cash reserve.
c. Observe all applicable corporate governance standards as prescribed by the CBN and other financial service sector regulatory authorities in Nigeria.
d. Design, comply with and implement an internal control framework and reports in accordance with the standards that the CBN may prescribe from time to time.
e. Through its Board of Directors report on the implementation and effectiveness of its internal control framework to the CBN within four months after the end of its financial year.
f. Be required to design, comply with and implement a risk management framework which ensures that the International Commercial Bank has an appropriate reporting structure, quality, procedure and technology to effectively and adequately identify, measure, monitor and report risks to the CBN, in accordance with any guidelines, circulars or regulations as prescribed by the CBN from time to time.
g. Without prejudice to the standards prescribed from time to time by the Nigerian Accounting Standards Board, be required to maintain its books and financial statements in accordance with the IFRS accounting standards.

The regulation resulted in the inception of the following commercial banks as international banks:

i) Zenith Bank Plc;
ii) Guaranty Trust Bank Plc;
iii) United Bank for Africa Plc;
iv) First Bank of Nigeria Plc;
v) Access Bank Plc;
vi) Diamond Bank Plc;
vii) Fidelity Bank Plc;
viii) Skye Bank Plc;
ix) First City Monument Bank Plc;
x) Bank PHB Plc; and
xi) Union Bank of Nigeria Plc.

SELF-ASSESSMENT EXERCISE 1

Mention and explain the three types of commercial banks in operation in Nigeria.

3.2 Merchant Banks

Presently there are two merchant banks in Nigeria namely Rand Merchant Bank and FSDH Merchant Bank; both commencing banking operations in the year 2013.

3.2.1 Operational Guidelines for Merchant Banks

The operational guidelines for merchant banks operations in the country, which are wholesale side of banking, according CBN regulations in 2010, include the following:

i. Take deposits from any natural or legal person, in an amount not below the sum of [One Hundred Million Naira] [N100,000,000.00] per tranche, or such other minimum amount as may be prescribed by the CBN from time to time;
ii. Provide finance and credit facilities to non-retail customers;
iii. Deal in foreign exchange and provide foreign exchange services, subject to the requirements of the *Foreign Exchange (Monitoring & Miscellaneous Provisions, etc.) Act Cap. F35 Laws of the Federation of Nigeria 2004, or any other laws and* CBN Regulations made pursuant thereto;
iv. Act as issuing house, or otherwise manage, arrange or coordinate the issuance of securities, for or on behalf of any person, subject to the provisions of BOFIA;
v. Provide underwriting services with respect to equity issuance of securities, subject to the provisions of BOFIA, and prior notification in writing to the CBN;
vi. Provide treasury management services including the provision of money market, fixed income, and foreign exchange investment on behalf of clients;
vii. Provide financial, consultancy and advisory services relating to corporate and investment matters, for a fee;
viii. Provide asset management services, including fund and portfolio management services, act as a dealer of securities for its own account, and for the account of *Permitted Activities.*

Merchant Banks are not permitted to carry out the following business activities:

a) Accept any deposit withdrawable by cheques;
b) Grant retail loans or engage in any form of retail banking;
c) Hold for more than six months any equity interest acquired in a company while managing an equity issue, subject to the provision of BOFIA;
d) Provide Insurance underwriting services, Loss adjusting services, Re-insurance services, and such other insurance related services; and
e) Any other business activities that may be restricted by the CBN from time to time.

3.2.2 Minimum Standards for Merchant Banks

A Merchant Bank shall:

i) Maintain a minimum paid-up share capital of [Fifteen Billion Naira] [15,000,000,000.00] or such other amount as may be prescribed by the CBN from time to time.

ii) Comply with all prudential guidelines and regulations issued by the CBN on the required level of capital adequacy, liquidity and cash reserve.

iii) Observe all applicable corporate governance standards as may be prescribed by the CBN and other financial service sector regulatory authorities in Nigeria.

iv) Design, comply with and implement an internal control framework in accordance with the standard that the CBN may prescribe from time to time.

v) through its Board of Directors report on the implementation and effectiveness of its internal control framework to the CBN within four months after the end of its financial year and the auditors of the Merchant Bank shall be required to include a statement in the annual Audit Report of the Merchant Bank as to the existence, adequacy and effectiveness or otherwise of such internal control systems.

vi) Design, comply with and implement a risk management framework which ensures that the Merchant Bank has an appropriate reporting structure, quality, procedure and technology to effectively and adequately identify, measure, monitor and

report risks to the CBN, in accordance with any guidelines, circulars or regulations as prescribed by the CBN from time to time.

vii) Without prejudice to the standards prescribed from time to time by the Nigerian Accounting Standards Board, be required to maintain its books and financial statements in accordance with the IFRS accounting standards, subject to the provisions of Section 28 of BOFIA.

SELF-ASSESSMENT EXERCISE 2

What are the operational guidelines for running merchant banks in the country?

3.3 Development Banks

Development banks are the special banks that have been established by the government to undertake special tasks of development in the economy such as providing loanable funds for long-term and medium-term to the various industrial undertaking undertakings in the country. Hence they aid the expansion of the economy towards the growth and development of the nation. The various ones in existence are for manufacturing sector, agricultural sector, housing sector and small scale industries industrial sector in order to boost industrialization of the economy. The notable ones among them are identified and discussed below.

3.3.1 Bank of Industry

This was set up to help boost the work operations of the industrial sector, especially, to aid the firms operating in the manufacturing and mining sectors of the economy. It makes loan available to large, medium and small enterprises. The bank inherited the assets and liabilities of the Nigeria Industrial Development Bank, Nigeria Bank of Commerce and Industry, and National Economic Reconstruction Fund (NERFUND).

The Bank performs the following functions:

1. It is to provide loan in the form of long term and medium terms or share participation;
2. It is to make fund available for re-investment by causing the transfer of share and securities;
3. It is to sponsor and underwrite any issues and conversion of shares and securities;
4. Guaranteeing loans and obligations;

5. Furnishing managerial and technical advisor services;
6. Give out loans to finance small and medium term investments;
7. Lease out equipment to the customers;
8. Give financial advice to their clients
9. Help to promote industrial projects
10. Promoting and developing viable projects f0r investment
11. It is to give consultancy services through financial and technical advices.
12. It is to support the implementation of projects financed by the bank
13. It fosters the development of capital markets in Nigeria, by encouraging prospective borrowers to be listed on the stock exchange.

3.3.2 Bank of Agriculture

The bank took over the assets and liabilities of the defunct Nigerian Agricultural, Cooperative and Rural Development Bank. In general terms, the bank has been established to make loan available to existing and prospective farmers that are willing to farm and have their landed property but do not have the financial power to buy crops, fertilizers and farm machines to produce in large quantity.

This loan facility for agricultural undertakings usually last for a minimum of five to fifteen years. The statutory functions of this bank, among others, include the following:

1. Grant loans for agricultural productions and storage distribution and marketing of agricultural products.
2. Granting direct loans to individual farmers and corporative societies or other bodies provided the projects are viable and there is an adequate security.
3. It engages in other activities to promote agricultural productions.
4. It helps to boost food supply in the economy and provide safety to the storage of farm produce.

3.3.3 Federal Mortgage Bank of Nigeria

This development bank has been established to take care of development of the housing sector of the economy. The statutory functions of this bank, among others, which include the following.

1. Provision of long term credit facilities to mortgage Institutions.
2. Encouragement and promotions of development of mortgage institutions at state and local level.

3. Supervision and control of the activities of mortgage institutions in Nigeria.
4. Carrying out research on mortgage finance activities and housing patterns and standard of offering financial advice to companies engaged in building and materials selling.
5. It is saddled with the responsibility of controlling primary mortgage institutions.
6. It is to raise the necessary fund through acceptance of savings and deposit from the public and investing society.
7. Promotion of housing fund through payments of interest rate.
8. Granting of loans and advances for the purpose of constructing dwelling places.
9. Looking after of old houses and seeing to their repairs of existing houses.
10. This supervises other building societies

SELF-ASSESSMENT EXERCISE 3

List the types of development banks operating in the country. What are their respective functions?

3.4 Non-Interest Banking

The Islamic banking or non-interest banking operations (e.g. Jaiz International) in Nigeria are carried out under the CBN guidelines, which are being adhered to by those corporate entities that engage in this type of banking genre.

3.4.1 Categorisation and Permissible Transactions of Non-Interest Banking

Non-interest banking and finance models are broadly categorized into two:

1. Non-interest banking and finance based on Islamic commercial jurisprudence; and
2. Non-interest banking and finance based on any other established non-interest principle.

Islamic banking as one of the models of non-interest banking, serves the same purpose of providing financial services as do conventional financial institutions save that it operates in accordance with principles and rules of Islamic commercial jurisprudence that generally recognizes profit and loss sharing and the prohibition of interest, as a model.

There are other non- permissible transactions which include those involving any of the following considerations:

i) uncertainty or ambiguity relating to the subject matter, terms or conditions;
ii) gambling;
iii) speculation;
iv) unjust enrichment;
v) exploitation/unfair trade practices;
vi) dealings in pork, alcohol, arms & ammunition, pornography; and
vii) other transactions, products, goods or services which are not compliant with the rules and principles of Islamic commercial jurisprudence.

SELF-ASSESSMENT EXERCISE

Explain the term Islamic banking. Mention the areas of non- permissible transactions under Islamic banking operations.

All the operational guidelines for the establishment and running of Islamic banks are based the:

i) Non-Interest banking regime under Section 33 (1) (b) of the CBN Act 2007;
ii) Sections 23(1) 52; 55(2); 59(1)(a); 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended) and Section 4(1)(c) of the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010' and
iii) It shall be read together with the provisions of other relevant sections of BOFIA 1991 (as amended), the CBN Act 2007, Companies and Allied Matters Act (CAMA) 1990 (as amended) and circulars/guidelines issued by the CBN from time to time.

3.4.2 Establishment and Operation of an Islamic Subsidiary Window or Branch of a Conventional Bank

The regulations for Establishment and Operation of an Islamic Subsidiary Window or Branch of a Conventional Bank are as follows:

1. Conventional banks and other financial institutions operating in Nigeria may offer or sell products and services in line with the principles under this model through subsidiaries, windows or branches only.

2. An Islamic subsidiary of a conventional bank or financial institution shall be established in line with the licensing requirements for the establishment of a full fledged non-interest financial institution.

3. An Islamic window or branch of a conventional bank or financial institution shall be established and operated in line with the guidelines on windows/branches issued by the CBN.

4. CBN Advisory Council of Experts.

There shall be an advisory body to be called CBN Advisory Council of Experts (ACE) to advise the CBN on matters relating to the effective regulation and supervision of IIFS in Nigeria. The qualification, duties, responsibilities etc of members of the Council are contained in guidelines to be issued by the CBN.

3.4.3 Conduct of Business Standards

1. Branding

Branding is in line with the provisions of Section 39 (1) of BOFIA 1991 (as amended), the registered or licensed name of an Islamic bank shall not include the word "Islamic", except with the consent of the Governor of the CBN. Islamic bank shall, however, be recognized by a uniform symbol designed by the CBN. All the signages and promotional materials of Islamic bank shall bear this symbol to facilitate recognition by customers and the general public.

2. Approval of Contracts, Products and Services

All contracts, products and services offered or proposed to be offered by Islamic bank shall be reviewed and approved by each institution's ACE. The introduction of new products/services shall require the prior written approval of the CBN.

3. Product Literature

An Islamic bank shall state in its product literature/marketing materials the ACE (indicating names of all the members) that certified the product or services being offered.

4. Profit Sharing Investment Accounts

i) An Islamic bank shall ensure that relevant disclosures are made to Profit Sharing Investment Accounts (PSIA) holders in a timely

and effective manner and also ensure the proper implementation of investment contracts.

ii) An Islamic bank shall inform its prospective PSIA client(s) operating under profit-sharing, loss-bearing contracts, in writing that the risk of loss rests with the client(s) and that the institution will not share in the loss unless there is proven negligence or misconduct for which the institution is responsible.

iii) Islamic bank with PSIAs may maintain a Profit Equalization Reserve (PER) which would serve as an income smoothing mechanism and risk mitigation tool to hedge against volatility of returns to investment account holders. They may also maintain an Investment Risk Reserve (IRR) to cushion against future losses for PSIA holders.

iv) The basis for computing the amounts to be appropriated to the PER and IRR should be pre-defined and disclosed.

5. Audit, Accounting and Disclosure Requirements

i) All Islamic bank shall comply with relevant provisions of the circular issued by the CBN on disclosure requirement by financial institutions and other disclosure requirements contained in CAMA 1990 (amended) and BOFIA 1991 (as amended).

ii) In addition, they shall comply with the relevant standards on disclosure issued by standards-setting organisations including: Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI); Islamic Financial Services Board (IFSB); and Nigerian Accounting Standards Board (NASB).

iii) All Islamic banks shall comply with the requirements of section 29 of BOFIA 1991 (as amended) and applicable guidelines/directives issued by the CBN as well as the relevant provisions of CAMA 1990 (as amended) regarding the appointment, re-appointment, resignation, rotation, change and removal of auditors.

iv) All Islamic banks shall comply with the Generally Accepted Accounting Principles (GAAP) codified in local standards issued by the NASB and the International Financial Reporting Standards (IFRS)/International Accounting Standards (IAS). For transactions, products and activities not covered by these standards, the relevant provisions of the financial accounting and auditing standards issued by the AAOIFI shall apply.

v) Where there is a conflict between the local and international standards, the provisions of the local standard(s) issued by NASB shall apply to the extent of the inconsistency. All Islamic banks shall have an internal review and audit mechanism to examine and evaluate on periodic basis the extent of compliance with the rules and principles pertinent to this model.

3.4.4 Prudential Requirements and Management of Risk Exposure

1. Minimum Capital Adequacy Ratio

All Islamic banks shall maintain a minimum Capital Adequacy Ratio (CAR) as may be prescribed by the CBN from time to time. The minimum Capital Adequacy Ratio (CAR) for Islamic banks shall be consistent with the prevailing CAR as may be prescribed for conventional banks and financial institutions by the CBN from time to time.

2. Liquidity Management

i) All Islamic banks are required to put in place appropriate policies, strategies and procedures which ensure that they maintain adequate liquidity at all times to fund their operations.

ii) Islamic banks shall not invest their funds in interest-bearing securities or activities. They are required to invest their funds in eligible instruments for the purpose of meeting the CBN prescribed minimum liquidity ratio. Liquid assets shall be held in line with the provision of section 15 of BOFIA 1991 (as amended), provided they comply with the principles under this model.

iii) All Islamic banks are expected to comply with other prudential requirements on exposure and concentration limits as may be prescribed by the CBN from time to time and standards of best practices.

iv) All Islamic banks are required to put in place appropriate policies, systems and procedures to identify, measure, monitor and control their risk exposures. In addition, they are required to put in place a risk management system that recognizes the unique risks faced by Islamic banks such as displaced commercial, fiduciary, transparency, reputational, equity investment and rate of return risks.

iv) Further details and guidance are provided in documents issued by the CBN and international standard setting organizations including:

a) CBN Prudential Guidelines;
b) Risk Management Guidelines issued by the Basel Committee on Banking Supervision; and
c) IFSB Guiding Principles of Risk Management for Institutions Offering only Islamic Financial Services.

3.4.5 Other Operational Regulations

1. Cross-Selling of Products/Services and Shared Facilities

The Islamic subsidiaries, windows or branches may operate using the existing facilities or branch network of the conventional bank. The subsidiary, window or branch shall however, not sell products/services that do not comply with the principles under this model.

2. Execution of Service Level Agreements in Respect of Shared Services

Conventional banks or other financial institutions with Islamic subsidiaries, branches or windows shall execute Service Level Agreements (SLA) in respect of shared services with their subsidiaries, branches or windows.

3. Intra-Group Transactions and Exposures

All transactions and exposures between an Islamic subsidiary, window or branch of a financial institution and the parent shall be in accordance with the principles and practices under this model.

SELF-ASSESSMENT EXERCISE 4

Discuss the term Non-Interest banking.
List the types of transactions that they can undertake in Nigeria.

3.5 Microfinance Banks

3.5.1 Categorization of Microfinance Banks

The National Microfinance Policy Framework for Nigeria of July 12th 2011 provides the following categorization of Microfinance Banks in the country.

Category 1: **Unit Microfinance Bank**

A Unit Microfinance Bank is authorized to operate in one location. It shall be required to have a minimum paid up capital of N20 million (twenty million Naira) and is prohibited from having branches and cash centres.

Category 2: State Microfinance Bank

A State Microfinance Bank is authorized to operate in one State or the Federal Capital Territory (FCT). It shall be required to have a minimum paid up capital of N100 million (one hundred million Naira) and is allowed to open branches within the same State or the FCT, subject to prior written approval by the CBN for each new branch.

Category 3: National Microfinance Bank

A National Microfinance Bank is authorized to operate in more than one State including the FCT. It shall be required to have a minimum paid up capital of N2 billion (two billion Naira), and is allowed to open branches in all States of the Federation and the FCT, subject to prior written approval by the CBN.

There are steps involved in Transformation Path of microfinance banks such as follows.
i. A Unit MFB that intends to transform to a State MFB shall be required to surrender its license and obtain a State MFB license, subject to fulfilling stipulated requirements.

ii. A State MFB that intends to transform to a National MFB must have at least 5 branches which are spread across the Local Government Areas in the State. This is to ensure that the MFB has gained experience necessary to manage a National MFB. It shall also be required to surrender its license and fulfill other stipulated requirements.

3.5.2 Ownership of Microfinance Banks

i. Microfinance Banks can be established by individuals, groups of individuals, community development associations, private corporate entities, NGO-MFIs, or foreign investors.

ii. No individual, group of individuals, their proxies or corporate entities, and/or their subsidiaries, shall own controlling interest in more than one MFB, except as approved by the Central Bank of Nigeria.

3.5.3 Participation of Existing Financial Institutions in Microfinance Activities

1. Deposit Money Banks:

Deposit Money Bank (DMB) wishing to engage in microfinance services can continue to do so through a designated Department/Unit and/or offer microfinance as a financial product. Nothing prevents the Holding Company having a DMB as a subsidiary from investing in or owning an MFB.

2. Non-Governmental Organization-Micro Finance Institutions (NGO-MFIs):

This policy recognizes the existence of credit-only, membership-based microfinance institutions, which are not required to come under the regulatory and supervisory purview of the CBN. They are however supervised by the appropriate Ministry. Such institutions shall engage in the provision of microcredit to their targeted population but shall not mobilize deposits from the general public.
The registered NGO-MFIs shall be required to forward periodic returns on their activities to the CBN primarily for statistical purposes. NGO-MFIs wishing to obtain operating licenses as Microfinance Banks shall be required to meet the stipulated provisions in the Regulatory and Supervisory Guidelines for MFBs in Nigeria.

3. Transformation of the Existing NGO-MFIs and Financial Cooperatives:

An existing NGO-MFI or Financial Cooperative which intend to operate as MFB can either incorporate a subsidiary MFB while still carrying out its NGO operations or transform to a MFB. Such institutions must obtain operating licence and shall be required to meet the stipulated provisions in the revised Regulatory and Supervisory Guidelines for MFBs.

SELF-ASSESSMENT EXERCISE 5

i. Discuss the term microfinance bank.
ii. What are the peculiar functions of the microfinance banks?

4.0 SUMMARY

There are many types of banks that are in operation in Nigerian economy. We have seen from the discussion that such banks include: commercial banks that have just come out of universal banking regime,

thus necessitating the establishment of some merchant banks; development banks established by the government to take care of development of the economy in various sectors. In other countries of the world, the non-interest banks are called Islamic banks, which imply that the non-interest banks in Nigeria are simply Islamic banks.

5.0 CONCLUSION

In the course of analysis in this study unit, we discussed types of bank operating in Nigeria. In the course of the discussion, we espoused on banking genres such as: Commercial banks; merchant banks; Development Banks (Bank of Industry, Bank of Agriculture, Federal Mortgage Bank of Nigeria); Commercial banks; merchant banks; Development Banks (Bank of Industry, Bank of Agriculture, Federal Mortgage Bank of Nigeria); Non-Interest Banking; and Microfinance Banks. In the next study unit, we shall discuss banker and customer relationship.

6.0 TUTOR-MARKED ASSIGNMENT

1. Mention and discuss the various types of banks that operate in the Nigerian economy.
2. Explain Non-Interest banking. What are the areas of difference between this type of bank and commercial banks?

7.0 REFERENCES AND MATERIALS FOR FURTHER READING

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UNIT 3 BANKER AND CUSTOMER RELATIONSHIP

CONTENTS

1.0 INTRODUCTION

There exists a peculiar relationship between the banks and their customers. This relationship has been described in various ways. The various views on such relationship is indicative of the fact that banks cannot exist without customers and customers cannot transact banking business without banking institutions. This makes this relationship a mutual one and very beneficial to both parties. Therefore, in this initial study unit of the material, we shall discuss banker and customer relationship.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of relationship of banker and customer
- differentiate between a Banker and a Customer
- discuss the relationship between a banker and customer
- identify important areas of banker-customer relationship.

3.0 MAIN CONTENT

3.1 Nature of Banker-Customer Relationship

Banker customer relationship is contractual in which a person entrusts valuable items with another person with an intention that such items shall be retrieved on demand from the keeper by the person who so entrusts.

This implies that the banker is the one who is entrusted with monetary items and other valuables, which the person who so entrusts such items, called customer, wishes to retrieve them on demand in course of dealing with the banker.

Since the relationship is on contractual basis, it is hinged on certain terms and conditions. For instance, the customer has the right to collect his deposit such as money on demand personally or through his proxy. Thus the banker too is under obligation to pay so long the proxy is duly authorized by the customer. Somehow, the relationship has some trappings of creditor /debtor relationship. Thus the customer is the creditor who has the right of demand on the monetary value in account from the banker.

The banker is invariably indebted to the customer as long as the banker is keeping the customer's monetary value and other valuable items. The relationship is also fiducial, and therefore, the banker is duty bound not to leak the terms and conditions governing the relationship to a third party, particularly without customer's knowledge and consent. In related terms, the items being kept with the banker should not be released to a third party without due authorization by the customer.
Fundamentally, the relationship between a banker and customer comes into existence when the banker agrees to open an account in the name of the customer. The relationship between bank and customer is based on simple contract, which takes effect from the moment a transaction is initiated by the customer and the banker accepts to keep account for the customer (Patel, 2012).

SELF-ASSESSMENT EXERCISE 1

Discuss briefly the nature of banker-customer relationship.

3.2 Meaning of a Banker and a Customer

3.2.1 Who Is a Banker?

In terms of popular definition, Herbet L. Hart posits that:

A banker or a bank is a person or a company carrying on the business of receiving money, and collecting drafts, for customers, subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts.

According to this definition, the essential function of a banker is the acceptance of deposits of funds withdrawable on demand. Sir John Paget

states that no one can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques, crossed and uncrossed, for customers. He further adds that if the banking business carried on by any person is subsidiary to some other business, then such a person cannot be regarded as a banker.

Section 3 of the Negotiable Instruments Act of 1881, which corresponds with Section 2 of the Bills of Exchange Act of 1882, it states that the term 'banker' includes persons, or a corporation, or a company acting as bankers. According to the Banking Company Ordinance 1962, banking has been defined as accepting for the purpose of lending or investment of deposits of money from public repayable on demand or otherwise and withdrawals by cheques, draft or order.

Under Section 5(1) of the Banking Regulation Act, 1949, a banking company is defined as "any company which transacts the business of 'banking'." Under Section 5(1)(b) 'banking' means accepting for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.

3.2.2 Who Is a Customer?

In simple terms, a customer is such a person to whom the bank extends its services in return for consideration. In broad terms, a customer is a person who maintains an account with the bank without taking into consideration the duration and frequency of operation of his account. In other words, the customer is a person who maintains a regular account with the bank without taking into consideration the duration and frequency of operation of his account.

In order to qualifier as a customer of any bank the individual should have an account with the bank. The individual should deal with the bank in its nature of regular banking business. He should deal with the bank without consideration of the duration and frequency of operation of his account. The relationship between banker and customer is of utmost importance.

The legal decisions on the matter are very valuable herein. Thus in *Great Western Railway Company Vs. London and County Banking Company*, a customer was defined as a person who has some sort of an account, either deposit or current account, or some similar relation with a banker. It implies that any person or corporate body may become a customer by opening a deposit account or current account, or by negotiating art advance on current or loan account.

According to Sir John Paget, to constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business.

As far as the condition that the transaction should be the nature of regular banking business is concerned there is unanimity. A casual transaction like encashment of a cheque cannot be considered to constitute a person as a customer of a bank. But it is difficult to reconcile with the idea of Sir John Paget when he states that, there must be some recognizable course or habit of dealing in order to constitute a person as a customer of a bank. According to this view, a single transaction will not constitute a customer.

A more acceptable view on definition of customer of a bank was expressed in *Ladbrok Vs Todd.* According to the Learned Judge:

> The relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection. It is no necessary that the person should have drawn on any money or even that he should be in position draw any money.

Therefore, neither the number of transactions nor the period during which business has been conducted between the parties is material in determining whether or not a person is a customer.

The same view was expressed in the case of *Commissioners of Taxation Vs English, Scottish and Australian Bank Ltd.* The Learned Judge observed:

> The word 'customer' signifies a relationship in which duration is not of essence. A person whose money has been accepted by the bank on the footing that they undertake to honour cheques up to the amount standing to his credit is a customer of the bank in the sense of the statute irrespective of whether his connection is of long or short standing. The contrast is not between a habitual and a newcomer but between a person for whom the bank performs a casual service, e.g., cashing a cheque for a person introduced by one of their customers, and a person who has an account
> of his own at the bank.

Hence mere opening of an account will constitute a person as a customer of a bank, irrespective of whether the connection is of long or short standing over a period of time.

SELF-ASSESSMENT EXERCISE 2

i. Differentiate between a banker and a customer.
ii. What constitutes a "customer" of a bank?

3.3 Relationship between a Banker and a Customer

In terms of the nature of relationship that exists between a banker and customer, John Paget holds that "The relation of a banker and a customer is primarily that of debtor and creditor the respective position been determined by the existing state of the account." The customer becomes a creditor and the banker becomes debtor when money is deposited in the bank account. The relationship becomes opposite when a customer becomes debtor and bank becomes creditor at the instance when loan is advanced.

When a customer deposits money in a bank the relationship of debtor and creditor is established. When a customer pays in money to the credit of his account, the banker becomes the debtor and when a bank grants loan or other credit facilities to the customer, relationship is reversed when a customer becomes the creditor by depositing funds in his account, but when the banker makes a loan to a customer the position is reversed, as the customer is then the debtor and the banker the creditor.

The money which a banker receives from a customer is at the free disposal of the banker; he may preserve it in his till, invest it in some security, or lend it out to another customer; but the customer retains the right to demand back a similar amount, or to draw cheques upon the banker up to that sum, the cheques being payable either to the customer himself or to some other person. The customer may also accept bills and arrange with the banker that they be charged to his account at maturity, or he may, in certain cases, make arrangements for the banker to accept bills on his behalf.

In order to constitute for a person to constitute a customer, Lord Davey held posited in Great Western Railway v. London and County Banking; Co. (1901, A.C. 414) that: " I think there must be some sort of account, either a deposit or a current account or some similar relation." When money has lain dormant with a banker for six years, the Statute of Limitations no doubt applies, as in an ordinary case of debtor and creditor, but a banker never takes advantage of the statute, and is always ready to repay the money upon the demand of the customer or of his legal representatives. (See Statute Of Limitations, Unclaimed balances)

If a customer leaves with his banker a parcel of securities for safe custody, the banker's position is that of a bailee, and his liability depends

to a certain extent, upon whether he undertakes the duty gratuitously or for reward. The difference between a banker as a debtor to his customer and as a bailee may be explained with illustration as follows: Ahmadu Bello pays in N200,000 to the credit of his account, the banker becomes Bello's debtor and is liable to repay to Bello on demand, but until the demand is made the banker can do what he desires with the money, and nevertheless, the N200,000 which is ultimately repaid to Bello is not, of course, the same money that was originally handed to the bank by Bello (example does not adequately portray bailee).

3.4 Important Areas of Banker-Customer Relationship

According to Akrani, G. (2012), the relationship between banker and customer is mainly that of a debtor and creditor. However, they also share other relationships. The banker-customer relationship is that of a: Debtor and Creditor; Pledger and Pledgee; Licensor and Licensee; Bailor and Bailee; Hypothecator and Hypothecatee, Trustee and Beneficiary; Agent and Principal; and Advisor and Client, among other miscellaneous relationships. Discussed below are important banker-customer relationships.

1. Relationship of Debtor and Creditor

When a customer opens an account with a bank and if the account has a credit balance, then the relationship is that of debtor (banker / bank) and creditor (customer).

In case of savings / fixed deposit / current account (with credit balance), the banker is the debtor, and the customer is the creditor. This is because the banker owes money to the customer. The customer has the right to demand back his money whenever he wants it from the banker, and the banker must repay the balance to the customer.

In case of loan / advance accounts, ***(the)*** banker is the creditor, and the customer is the debtor because the customer owes money to the banker. The banker can demand the repayment of loan/advance on the due date, and the customer has to repay the debt. A customer remains a creditor until there is credit balance in his account with the banker. A customer (creditor) does not get any charge over the assets of the banker (debtor). The customer's status is that of an unsecured creditor of the banker.
The debtor-creditor relationship of banker and customer differs from other commercial debts in the following ways:

a) The creditor (the customer) must demand payment

On his own, the debtor (banker) will not repay the debt. However, in case of fixed deposits, the bank must inform a customer about maturity.

b) The creditor must demand the payment at the right time and place

The depositor or creditor must demand the payment at the branch of the bank, where he has opened the account. However, today, some banks allow payment at all their branches and ATM centres. The depositor must demand the payment at the right time (during the working hours) and on the date of maturity in the case of fixed deposits. Today, banks also allow pre-mature withdrawals.

c) The creditor must make the demand for payment in a proper manner

The demand must be in form of cheques; withdrawal slips, or pay order. Now-a-days, banks allow e-banking, ATM, mobile-banking, etc.

2. Relationship of Pledger and Pledgee

The relationship between customer and banker can be that of Pledger and Pledgee. This happens when customer pledges (promises) certain assets or security with the bank in order to get a loan. In this case, the customer becomes the Pledger, and the bank becomes the Pledgee. Under this agreement, the assets or security will remain with the bank until *(the)* customer repays the loan.

3. Relationship of Licensor and Licensee

The relationship between banker and customer can be that of a Licensor and Licensee. This happens when the banker gives a sale deposit locker to the customer. So, the banker will become the Licensor, and the customer will become the Licensee.

4. Relationship of Bailor and Bailee

The relationship between banker and customer can be that of Bailor and Bailee.

i. **Bailment** is a contract for delivering goods by one party to another to be held in trust for a specific period and returned when the purpose is ended.
ii. **Bailor** is the party that delivers property to another.

iii. **Bailee** is the party to whom the property is delivered.

Therefore, when a customer gives a sealed box to the bank for safe keeping, the customer became the bailor, and the bank became the bailee.

5. Relationship of Hypothecator and Hypothecatee

The relationship between customer and banker can be that of Hypothecator and Hypothe*(c)*atee. This happens when the customer hypothecates (pledges) certain movable or non-movable property or assets with the banker in order to get a loan. In this case, the customer became *(becomes)* the Hypothecator, and the Banker became *(becomes)* the Hypothecatee. [Not Clear]

Hypothecation is not to be confused with pledge because unlike pledge (where both the property in and possession of the goods are transferred to the lender), the goods hypothecated are accepted by the banker (hypothecatee) as security for the debt of the customer (hypothecator) but the banker does not retain the property in the goods nor possession of the goods. A written letter of acknowledgement by the customer is therefore needed to avow that the customer is holding the goods for the banker as bailee. Notwithstanding, the bank still depend on the credibility of the customer.

6. Relationship of Trustee and Beneficiary

A trustee holds property for the beneficiary, and the profit earned from this property belongs to the beneficiary. If the customer deposits securities or valuables with the banker for safe custody, banker becomes a trustee of his customer. The customer is the beneficiary so the ownership remains with the customer. *(Not good enough)*

[A customer (trustee) may entrust a security or valuables with a bank for the purpose of safekeeping usually for the benefit of the customer or a third-party (beneficiary). The banker in this case is the trustee and the customer or third-party is the beneficiary]

7. Relationship of Agent and Principal

The banker acts as an agent of the customer (principal) by providing the following agency services:

i. Buying and selling securities on his behalf,
ii. Collection of cheques, dividends, bills or promissory notes on his behalf, and

iii. Acting as a trustee, attorney, executor, correspondent or representative of a customer.

Banker as an agent performs many other functions such as payment of insurance premium, electricity and gas bills, handling tax problems, etc.

8. Relationship of Advisor and Client

When a customer invests in securities the banker acts as an advisor. The advice can be given officially or unofficially. While giving advice the banker has to take maximum care and caution. Here, the banker is an Advisor, and the customer is a Client.
[A customer may approach the bank for financial or investment advice or opinion whether officially or unofficially, the banker here becomes the advisor and the customer, the client. Caution must be taken however to not give negligent investment advice even to a person who is yet to be a customer as a wrong advice may result in an action of damages against the bank and it will stand as in the case of *Woods vs Martins Bank Limited (1958)*]

Miscellaneous banker-customer relationships include the following:

a) Obligation to honour cheques

In as much as there is sufficient balance in the account of the customer, the banker must honour all his cheques. The cheques must be complete and in proper order. They must be presented within six months from the date of issue. However, the banker can refuse to honour the cheques only in certain cases.

b) Secrecy of Customer's Account

When a customer opens an account in a bank, the banker must not give information about the customer's account to others [without the implied or express permission of the customer unless in some few exceptional cases which will be discussed later].

c) Banker's right to claim incidental charges

A banker has a right to charge a commission, interest or other charges for the various services given by him to the customer. For e.g. an overdraft facility.

d) Law of limitation on bank deposits

Under the law of limitation, generally, a customer gives up the right to recover the amount due at a banker if he has not operated his account since last 10 years.

SELF-ASSESSMENT EXERCISE 3

List and explain the important areas of banker-customer relationship.

3.5 Special Features of the Relationship

1. Appropriation of Payments

When money is paid in by the customer, or when the banker receives money from third parties for credit to the customer. The customer has a right to say that it should be placed to a particular account, or should be applied in payment of a particular debt or in meeting certain cheques or bills. The banker is bound to appropriate it accordingly, irrespective of the state of accounts between them. But if the customer does not make any specific appropriation, the banker can appropriate, and apply the payment even to a statute-barred debt. When the method of appropriation is communicated to the customer, it becomes irrevocable.

In case there is a current account, and neither the banker nor the customer makes any specific appropriation, then any successive payments will be appropriated in accordance with the *Rule in Clayton's Case.* According to this Rule, it is the first sum paid in that is first paid out. Thus, it is the first item on the debit side that is discharged or reduced by the first item on the credit side. It should be noted that the Rule applies only to a current or running account.

2. Banker's Right of Set-Off

As far as the banker's right of set-off is concerned, there is a conflict of judicial opinions. In *Garnett Vs Mckervan,* it was held that in the absence of a special agreement to the contrary, a banker might set-off a customer's credit balance against a debt due to him from the customer, and that there was no legal obligation on a bank to give notice to a customer about its intention to combine accounts.

Nevertheless, in *Greenhalgh and Sons vs Union Bank of Manchester,* the Learned Judge observed: “If the banker agrees with his customer to open two accounts or more; he has not in my opinion, without the assent of the customer, any right to move either assets or liabilities from one account to the other; the very basis of his agreement with his customer is that the two accounts shall be kept separate".

In view of these disagreeing judicial pronouncements, the banker can be on the safer side by entering into an agreement with the customer authorizing the banker to combine the accounts at any time without notice and to return cheques which, as a result of such an action, would overdraw the combined account.

Nonetheless, in cases such as the death or bankruptcy of the customer, in order to recover the net amount owing to him, the banker can exercise the right of set-off without notice even in the absence of an agreement.

At the same time, it may be noted that the right of set-off cannot be exercised by the banker if he has made some agreement, express or implied, to keep the accounts separate. This has been laid down in *Halesovven Presswork and Assemblies Ltd. Vs Westminster Bank Ltd.*

Another point to be noted in this connection is that the banker cannot exercise his right of set-off if the accounts are not in the same right. For instance, the banker cannot set-off the credit balance on a partner's account against a debt due on the partnership firm's account and *vice versa.* Further, the banker cannot combine a trust account with the personal account of the customer.

Again, the right of set-off applies only to existing debts and not to contingent liabilities. Thus in *Jefftyes Vs Agra and Masterman's Bank Ltd.,* the Learned Judge observed "You cannot retain a sum of money which is actually due against a sum of money which is only becoming due at a future date".

Furthermore, the right of set-off does not apply where the customer has deposited an amount taking a loan from a third party on condition that the money is repayable if not used for a particular purpose, the bank having been notified of this condition and where the customer is unable to utilize the loan due to liquidation, as was decided in *Quistclose Investments Ltd. Vs Rolls Razar Ltd. (involuntary liquidation) and Other.*

3. Banker's Obligation to Honour His Customer's Cheques

Section 31 of the Negotiable Instruments Act, 1881 imposes a statutory obligation upon the banker to honour the cheques of his customer drawn against his current account so long as his balance is sufficient to allow the banker to do so, and provided the cheques are presented within a reasonable time after their ostensible date of issue. The Section runs as follows:

"The drawee of a cheque having sufficient funds of the drawer in his

hands, properly applicable to the payment of such cheque must pay the cheque when duly required so to do and in default of such payment must compensate the drawer for any loss or damage, caused by such default."

The statutory obligation may be extended by an agreement, express or implied, to the amount of overdraft agreed upon. But after giving sufficient notice, a banker can withdraw any overdraft limit already granted. In *Rouse vs Bradford Banking Company*, wherein it was held that "it may be that an overdraft does not prevent the bank who has agreed to give it, from at any time giving notice that it is no longer to continue and they must be paid their money". But if the bankers "have agreed to give an overdraft, they cannot refuse to honour cheques, or drafts, within the limit of that overdraft, which have been drawn and put into circulation before any notice is given to the customer that the limit is withdrawn".

Previous to dishonouring a customer's cheque the banker must ascertain that prevailing circumstances permit him to do so. Otherwise, he will be liable to pay damages to the customer for injuring his credit. A businessman can recover substantial damages without pleading and proving actual damage, as was the case in *Robin Vs Steward.* But in the case of a non-trading customer, only nominal damages will be awarded unless the damages are alleged and proved as special damages, as in the instance of *Gibbons vs Westminster Bank Ltd.* In this connection, it may be mentioned that the accidental dishonour of a cheque for a small amount constitutes greater damage to the credit of the customer than the dishonour of a cheque for a larger amount, a view which was held in *Davidson vs Barclays Bank Ltd.*

In addition, when computing the customer's balance, the banker need take into account his credit balance only at the branch on which the cheque is drawn. Though the bank had the right to combine several accounts of the customer, the customer had no right to insist that the bank combine different accounts in determining whether a cheque on an account may be dishonoured. The following passage from Halsbury's Laws of England is relevant herein:

Unless precluded by agreement, express or implied from the course of business, the bank is entitled to combine different accounts in his own right even though at different branches of the same bank, and to treat the balance, if any, as the only amount standing to his credit....

The customer, however, has not the equivalent right, and cannot utilize a credit balance at one branch for the purpose of drawing cheques on another branch where he has no account or where his account is overdrawn."

In the absence of an express or implied agreement giving the customer a right to draw cheques against uncleared items, the banker is entitled to return such cheques with the answer 'effects not cleared', as Way held in *Underwood Vs Barclays Bank Ltd.* Here, It should be remembered that an implied agreement would arise from some established course of business. Thus, if the banker has been following the practice of honouring his customer's cheques drawn against uncleared items, he cannot, return cheques with the answer 'effects not cleared' without reasonable notice.

The duty of the banker to honour his customers cheques, unless improperly drawn, does not apply to bills of exchange accepted by the customer and made payable by the banker. Here too, an implied agreement would arise from some established course of business.

The liability of a banker for wrongful dishonour of a cheque is only to the drawer and not the payee of the cheque. When a point arose for consideration in terms of whether a company, which is the holder of the cheque, can hold the drawee bank liable, Section 31 of the Negotiable Instruments Act, which deals with the liability of the drawee of a cheque becomes relevant. The said Section refers to the liability of the drawee to the drawer and not to the payee of the cheque.

There is no provision in the Negotiable Instruments Act that the drawee is much liable on the instrument, the only exception being under Section 31 in the case of a drawee of a cheque having sufficient funds of the customer in his hands, and even then, the liability is only towards the drawer and not the payee.

4. Banker's Duty to Maintain Secrecy of the Customer's Account

Due the peculiarly private character of transactions between the banker and the customer, the banker should not divulge the state of the customer's account to third parties, except on reasonable and proper causes. If the banker fails in his duty, he will be liable for damages, which may be substantial if the credit of the customer has suffered serious injury. According to Sir John Paget, this duty of the banker to maintain secrecy does not end even with the closing of the customer's account.

Further, it has been laid down in *Tournier vs National Provincial bank of England* that this secrecy applies not only to information derived by the banker from the customer himself or from his account, but also to information concerning the customer's credit that may come into the banker’s possession in his capacity as a banker. In the instant case, a

customer of the National Provincial Bank drew a cheque in favour of Tournier who, in turn, endorsed it in favour of a third party who had an account with another bank. On return of the cheque to the National Provincial Bank, the manager of the bank wanted to know to whom the cheque was paid. The manager was told that the person was a book-maker Tournier sued the National Provincial Bank on the ground that the manager disclosed information that Tournier was a book-maker. The Court held that the disclosure constituted a breach' of duty on the pan *[part]* of the National Provincial Bank towards Tournier.

However, the duty to maintain secrecy is not absolute, but qualified. The following qualifications have been cited as examples by the Learned Judge in the Tournier case quoted above.

1. Where disclosure is under compulsion of law
2. Where there is a duty towards the public to disclose
3. Where the interests of the bank require disclosure
4. Where the disclosure is made in accordance with the express or implied consent of the customer

In addition to the above qualifications, bankers have a practice of sharing opinions with one another concerning the creditworthiness of customers. In such cases, the banker should confine himself to general statements and not disclose the details of the account, unless specifically authorized to do so.

It is also important that the banker should not make statements which may make him liable for defamation or fraudulent misrepresentation. If the banker makes *any* statement knowing it to be false and if any third party suffers a loss for having relied on the statement, the banker will be held liable to the third party to whom the information is given.

Till recently, it was believed that as far as a banker's liability to a third party was concerned, he could not be held liable for any false information given negligently since there was no contractual relationship between the banker and a non-customer. But the decision in *Hedley Byrne and Co Ltd vs Heller and Partners Ltd.* indicates that action may be taken for professional negligence if third parties suffer financial loss due to their reliance on the professional skill and judgment of persons with whom they do not have a contractual or fiduciary relationship.

According to the facts of this case, before entering into a transaction with A, the plaintiffs sought a reference to A's standing from A's bankers. The bankers provided the reference, stating therein that they accepted no responsibility for its accuracy. The reference proved to be

misleading and the bankers had been negligent. As a result of the loss suffered by the plaintiffs, they sued the bankers for negligence. The House of Lords held:

(a) that the bankers could be held liable for negligence contained in a reference but
(b) that the disclaimer of liability in the reference exonerated them from liability on the particular facts of the case.

In the absence of an 'express' authority from the customer concerned the banker should decline to give any information in response to enquiries from an outsider who is not a banker. While declining to give information, care should be taken to see that he does not state anything which is likely to injure his customer's credit.

5. Banker's Lien

Another feature of the relationship between the banker and the customer is the banker's right of lien over securities that may come into the banker's possession in the normal course of business. A 'lien' may be defined as the right to retain property belonging to a debtor until he has discharged the debt due to the retainer of the property.

A distinction may be made between a 'general lien' and a 'particular lien'. A 'particular lien' confers the right to retain the goods in respect of a particular debt involved in connection with a particular transaction. A 'general lien' confers the right to retain goods not only in respect of debts incurred in connection with a particular transaction but also in respect of any general balance arising out of the general dealing between the two parties.

Banker's lien is a general lien. It has been held in *Brandao Vs Barnett* that bankers have a general lien on all securities deposited with them as bankers by a customer, unless there is an express contract, or circumstances that show an implied contract, inconsistent with the lien.

Relatedly, in the same judgment, a banker's lien has been defined as an implied pledge. An ordinary lien does not imply a power of sale, but a pledge does. However a banker's right of sale is generally regarded as extending to fully negotiable securities only. It is not clear whether the banker's right of sale extends to securities which are not fully negotiable. Most cases concerning lien have applied to negotiable securities and, in the absence of legal decision on the matter, it seems advisable to regard a banker's lien on nonnegotiable securities as conferring only a right to retain them until his demands have been satisfied.

There are cases where the banker cannot exercise his right of lien such as follows.

1. In the case of securities deposited with the banker purely for safe custody, the banker is acting as a bailee and has no lien over such articles.

2. In the case of funds and securities specifically appropriated, the banker cannot exercise his right of lien because there is an express contract inconsistent with the lien.

3. A bank has no right of lien on money deposited or credit balance earmarked by the customer for a specific purpose, although the right of lien applies if the bank has no express or implied notice of the purpose of the deposit.

4. Right of lien is not exercisable where documents or valuables are left with the banker inadvertently. But where the securities are left with the banker even after the loan for which the securities were given as collateral is repaid, right of lien is exercisable over them. By leaving the securities with the banker, the customer is supposed to have redeposited them with the banker, as was held by the House of Lords in the case of London and Globe Finance Corporation.

5. A general lien cannot arise in respect of property of a customer pledged as security for a particular debt.

6. The banker cannot exercise his right of lien in respect of property coming in by mistake, or which is placed with the bank to cover an advance that is not granted, as was held in *Lucas Vs Dorrien.*

7. No lien arises for an advance of a specific amount for a definite period until the due date.

8. No lien arises in case the credit and liability do not exist in the same right. Thus, the banker cannot exercise his right of lien over the securities or funds of a partner in respect of a debt due from the partnership firm.

9. The banker cannot exercise his right of lien over a separate account maintained by the customer, known to the banker as a Trust Account.

10. No lien arises over properties for whi*ch* the customer has no title.

6. Banker's Right to charge Interest and commission

A banker is entitled to charge interest on loans, either by express agreement or by right of custom or usage of trade. He is also allowed to charge compound interest unless there is an agreement to the contrary.

In the absence of an express agreement, or without due notice, a banker is not entitled to debit his charges at any other than the customary dates. And if the banker dishonours his customer's cheques owing to lack of funds by reason of his having done so, he may be held for unjustifiable dishonour.

The banker is also entitled to charge commission for service rendered to his customer.

7. Garnishee Orders

A garnishee order' is an order of the Court obtained by the Judgment creditor attaching funds in the hands of a third party who owes [the] judgment creditor money, warning the third party (the Garnishee) not to release money attached until directed by the Court to do so. For instance, if A obtains judgment in respect of a debt due to him from B, A may apply to the Court for a garnishee order attaching the funds in B's bank account.

Before issuing an absolute garnishee order, a garnishee order *nisi, is issued to the banker.* In the case of a garnishee order nisi, although the order attaching the funds in the hands of the banker (the garnishee), an opportunity is given to the banker to show cause why the funds should not be handed over to the judgment creditor. On the banker failing to show sufficient cause, the order is made absolute. The banker should not pay over funds until the order is made absolute since he has no authority for payment under an order *nisi.*

When a garnishee order is served on a banker, *he* should attach all funds due or accruing due. The term 'accruing due' means debts already incurred, but payable at a future date. It does not include debts which do not exist at the time the order is served. In the case of a current or savings bank account, although it might appear that a debt is not due until a demand for a repayment is made, the garnishee order itself operates as a demand for a repayment that is sufficient to render any money held in that account immediately repayable, as was held in the *Joachinison Case.* Thus, a current/savings bank account is attachable by a garnishee order. Similarly, a deposit account repayable on demand is attachable by a garnishee order.

Further, the following kinds of deposits are attachable:

i) A deposit repayable on fixed notice, provided the notice has been given before the order is received. However, under Section 38 of the Administration of Justice Act, 1956, a deposit account in England is attachable by a garnishee order, notwithstanding any condition about return of the *receipt* or the absence of a notice.

ii) A deposit repayable on a fixed date. In this case it is a debt accruing due.

Therefore, when the banker is served with a garnishee order, he should stop operations on the accounts of the customer. It must remain dormant until the order is discharged. Nevertheless, the banker can open a new account and operate it during the garnishee proceedings. The new account is not attachable by the garnishee order as it attaches only debts due or accruing due on the date when the order is served, and not future debts. Relatedly, in the case of a limited garnishee order (where the sum attachable is specified), the banker can transfer any credit balance to a new account with the consent of the customer, and this new account can be allowed to be operated freely.

Before paying the amount in accordance with a garnishee order, a banker is entitled to deduct all debts due to him on the date of the order from the customer's credit balance. For this purpose, he can combine all the accounts of his customer. But he is neither entitled to retain moneys against contingent liabilities nor is he entitled to transfer the balance in the current account to a loan account in order to defeat a garnishee order.

In England, the Court, by issuing a writ, commands the sheriff to seize the goods and bring them to the Court. Therefore in England, as soon as the garnishee order is served, the attaching creditor becomes a secured creditor. When pursuant to the order of attachment or by the coercive process, the moneys attached are actually brought into the Court.
As long as the attachment order is of a prohibitory nature, the creditor may not have any rights or security in the property; once the moneys are brought into the Court, the attaching creditor is entitled to insist that those moneys should be handed over to him in satisfaction of decree.

In *Halsbuty's Laws of England*, the judgment creditor is entitled to insist on payment to himself by the garnishee. The attaching creditor, having taken steps to obtain payment against the decree, cannot be told that the Court is holding moneys for the debtor, more so when the garnishee obtains complete discharge by making payment in the Court. In the result, the attaching creditor is held to be secured creditor.

In situation where funds are not attached by a garnishee order, the following prevail.

a) Funds coming into the banker's hands subsequent to the receipt of the garnishee order are not attached. This is because a garnishee order attaches funds due or accruing due as on the date of the garnishee order. It may be noted here that the date of attachment is material and not the date on which the application for attachment is made. In other words, the attachment of the debt due, to the judgment debtor is not illegal because application for attachment is made before it became due.

   The date of attachment, not the date on which the application for attachment was made, was material if the debt was due by the date on which the attachment was effected, there could not be any valid objection against the same, simply because the application for its attachment was made before it became due.

b) A joint account is not attached by a garnishee order, provided the order is issued against only one of the account holder.

*The decision in Macdonald Vs Tacquash Gold Mines C*o., in which a view was taken that a debt, legal or equitable, owing by a garnishee to a judgment debtor, should not be a debt due to him jointly with another person.

c) A partnership firm's account is not attached by a garnishee order provided the order is issued against only one of the partners.

d) In the case of an overdrawn account of a customer, the garnishee order will not attach funds even though the customer has not reached the agreed limit of overdraft when the order is served.

e) If a garnishee order does not correctly designate the judgment debtor and the account which he has with the bank, funds are not attached.

f) For amounts credited as cash in respect of uncleared items, it is doubtful whether they are attached by a garnishee order. In *Jones Vs Coventry*, it was held that they were attached by a garnishee order. However, in view of a later decision in *Underwood Vs Barclays Bank*, the earlier decision does not appear to hold good. The latter decision recognized the banker's right to return cheques drawn against uncleared items in the absence of a contract, express or implied, to the contrary.

In another a case, the decision in *Fern Vs Bishop & Co. Ltd. and Another* was upheld the decision in *Underwood Vs Barclays Bank.* In this case, a garnishee order was served on the debtor's bank for an amount of £806. The debtor's credit balance was £4,998, including £4,700 representing a cheque paid in for collection but not collected. The bank, having deducted the bank charges due to it, opened a new account for the £4,700 and left £218 to meet the judgment debt.

The Learned Judge stated that the question was whether at the time the garnishee order was served, the sum of £4,700 constituted a debt owed by the bank to the judgment debtor, whether the bank was holding the cheque in question as a holder for value. It was held in *Undenvood Vs Barclays Bank* that for a bank to become a holder for value there had to be a contract between the banker and the customer, express or implied, that the latter might draw against cheques which were not cleared. There was no evidence of such a contract in the above menstioned case.

As regards proving such a contract, if there were an express agreement, the bank would be duty-bound to disclose the fact to the judgment [cre]ditor, when served with a garnishee order *nisi. But* if such an agreement were to be implied from a course of conduct, it would be wrong for a banker L to offer details of a customer's banking transactions to any judgment creditor, who could use the machinery of discovery under the control of the Court. In the above case, this had not been done. Thus the garnishee order was made absolute in the sum of £218.

g) Until recently it was considered that a garnishee order could not attach a debt owing in a foreign currency. But the decision in *Choice Investments Ltd. Vs Jemnimon & Midland Bank Ltd* indicates that a garnishee order could even attach a credit balance maintained in a foreign currency. In this case the question was whether the garnishee order issued against the bank could attach funds in a US dollars Deposit Account maintained by the judgment debtor in England.

The Learned Judge outlined the procedure to be followed is thus that

...as soon as the garnishee order *nisi* it operates to 'freeze 'the sum in the hands of the bank, in this way; they must, as soon as reasonably practicable, in the ordinary course of business, put a 'stop order' in the requisite amount of US dollars. It should be such a number of dollars as, if realized at the time of the stop order, would realize the amount of the sterling judgment-at the buying rate of sterling ruling at the time of the stop order. The bank should not make a transfer into sterling at that

stage. But, if and when the garnishee order is made absolute, the bank should exchange that stopped amount from dollars into sterling so far as is necessary to meet the sterling judgment debt and pay over that amount to the judgment creditor. But if and so far as the stopped amount (owing to exchange fluctuations) is more than enough to meet the judgment debt, the bank must release the balance from the stop order and have it available to the customer on demand. If the stopped amount is, when the garnishee order is made absolute, by virtue of exchange fluctuations, insufficient to satisfy the judgment, remaining funds with the banks are not affected.

8. Banker - Customer Relationship in the Context of Bankers' Book Evidence Act

As observed earlier, a banker has to disclose the state f a customer's account under an order from a Court of law. Before the enactment of the Bankers' Book Evidence Act, 1891, a banker had to produce the actual books of accounts whenever he was summoned to do so by any of the parties to the suit. But the Bankers' Book$ Evidence Act provides that a certified copy of any entry in a banker's book shall in all legal proceedings be received as *prima facie* evidence of such entry, and of the matters, transactions and accounts recorded therein. Section 4 of the Act holds that:

A certified copy of any entry in a banker's book shall in all legal proceedings be received as prima facie evidence, of the existence of such entry, and shall be admitted as evidence of the matters, transactions and accounts therein recorded in every case where, and to the same extent as, the original entry itself is now by law admissible, but not further or otherwise.

Furthermore, Section 5 of the Act provides that a banker or officer shall not, in any legal proceedings to which the bank is not a party, be compelled to produce any banker's book, the contents of which can be proved under the Act, or to appear as a witness to prove the matters, transactions and accounts therein recorded, unless by order of the Court or a Judge made for a special cause. At the same time, if the bank is not a party in the action and if the Court is not satisfied that the certified copies produced are true copies of the accounts maintained by the bank, it is open to the Court to direct the bank authorities to produce the original books.

A 'certified copy' has been defined by the Act as a copy of any entry in the books of a bank together with the certificate written at the foot of such copy that it is a true copy of such entry, that such entry is contained in one of the ordinary books of the banker, and that such book is still in

the custody of the bank. The term "Banker's Books" includes ledgers, day books, cash books, accounts books and all other books used in the ordinary business of the bank.

A court or judge may also give any party to a legal proceeding leave to inspect and take copies of any entries in a banker's books. The relevant provision is contained in Section 6 of the Act which says:

i) On the application of any party to a legal proceeding, the court or Judge may order that such party be at liberty to inspect and take copies of any entries in a banker's books for any of the purposes of such proceeding, or may order the bank to prepare and produce, within a time period to be specified in the order, certified copies of all such entries that are to be found in the books of the bank relevant to the matters in issue in such proceeding, and such further certificate shall be dated and subscribed in a manner hereinbefore directed in reference to certified copies.

ii) An order under this or the preceding Section may be made with or without summoning the bank, and shall be served on the bank three clear days (exclusive of bank holidays) before the same is to be obeyed, unless the court or judge directs otherwise.

iii) The bank may, at any time before the time limited for obedience to any such order as aforesaid, either offer to produce their books at the trial, or give notice of their intention to show cause against such order, and thereupon the same shall not be enforced without further order.

In application under the Bankers' Book Evidence Act for an order upon a bank to supply a certified copy of the entries in respect of one of its customers for a particular periods may be allowed because it being a third party document, the same ought not to be allowed to be produced by this process unless special circumstances are shown. It may be noted here that if the bank is a party in the action, it can be compelled to produce its actual books under *sub-poena.*

Nevertheless, the exemption granted to bankers from producing their books under the Act in any legal proceeding to which the bank is not a party does not hold good in case of a police investigation.
An officer in charge of a police station can, by a written order, call upon a person to produce any documents which the police officer thinks relevant to the investigation he is carrying on. In other words, a police investigation is not a legal proceeding in the sense in which the term is employed in Section 5 of the Bankers' Book Evidence Act, on the

ground that a police investigation has nothing to do with evidence in its legal sense, which is the essence of legal proceeding.

Another important point to be noted here is that a certified copy of an entry in a banker's books is only *prima facie* evidence, and not conclusive evidence.

According to some observation by Leamor a cases imply that while the Bankers Evidence Act recognizes certified copies admissible by law as evidence, such admissibility is only to the same extent as the original entry itself, not further or otherwise. By reason of Section 34 of the Evidence Act, the original entries alone would not be sufficient by themselves to charge any person with liability and so, copies produced under Section 4 of the Bankers' Book Evidence Act cannot by themselves be sufficient to charge any person with liability.

SELF- ASSESSMENT EXERCISE 4

Differentiate Banker’s Lien and Garnishee Order.

4.0 CONCLUSION

Banker-customer relationship is the contractual type of relationship in which a person entrusts valuable items with another person with an intention that such items shall be retrieved on demand from the keeper by the person who so entrusts. Therefore, it is the banker who is entrusted with monetary items and other valuables, which the person who so entrusts such items, called customer, wishes to retrieve them on demand in course of dealing with the banker. Since the relationship is on contractual basis, it is hinged on certain terms and conditions, which must be adhered to by both parties.

5.0 SUMMARY

In this course of analysis in this study unit, we discussed issues such as the Nature of Banker-Customer Relationship, Meaning of a Banker and a Customer, distinction between a Banker and a Customer, Relationship between a Banker and a Customer, and Important Areas of Banker-Customer Relationships. In the next study unit, we shall discuss bank accounts of customers.

6.0 TUTOR-MARKED ASSIGNMENT

1. Different between a banker and a customer.
2. Mention and explain important areas of banker-customer relationship.

7.0 REFERENCES/FURTHER READING

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UNIT 4: BANK ACCOUNTS OF CUSTOMERS

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we discussed the relationship between the banks and their customers. The basis of such relationship is rooted in the various accounts being held by the customers with the banks. There are various forms of bank accounts that the banks do maintain for their customers. Such various forms of bank accounts, therefore, constitute the subject of discussion in this study unit of the material.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the meaning of bank account
- mention and discuss various types of bank accounts.

3.0 MAIN CONTENT

3.1 Meaning of Bank Account

A bank account is a financial account between a bank customer and a financial institution. A bank account can be a deposit account, a credit card, or any other type of account offered by a financial institution. The financial transactions which have occurred within a given period of time on a bank account are reported to the customer on a bank statement and the balance of the account at any point in time is the financial position of the customer with the institution. a fund that a customer has entrusted to a bank and from which the customer can make withdrawals.

Bank accounts may have a positive, or credit balance, where the bank owes money to the customer; or a negative, or debit balance, where the customer owes the bank money. Broadly, some accounts are opened with the purpose of holding credit balances over a period of time, which are referred to as deposit accounts. Some other accounts are opened with the purpose of holding debit balances such as the loan accounts. Some accounts can be switched between credit and debit balances.
Some of the customers' bank accounts are categorized by the function inherent in them rather than on the basis of the nature of the balances they hold, such as the savings accounts. In general terms, all banks have their own names for the various accounts which they open for customers.

SELF-ASSESSMENT EXERCISE 1

Discuss the meaning of a bank account.

3.2 Types of Bank Account of Customers

Generally, commercial banks offer a wide variety of accounts. Such accounts can be broadly divided into some distinct types: savings accounts, basic chequeing accounts, interest-bearing chequeing accounts, money market deposit accounts, and certificates of deposit, among others. All such accounts are in most cases insured by the appropriate deposit insurance corporations in some economies, based on lower and upper limits of the amount of balances in the customers' accounts depending on the practices in the economies around the world.
Most banks offer all of these types of accounts, offering the customers a wide range of choice in terms of their desirability. This is because the desire of individuals dictates the type of bank they may choose to open with the banks. The common types of bank accounts are identified and discussed as follows:

1. Savings Accounts

These are intended to provide an incentive for you to save money. You can make deposits and withdrawals, but usually can't write cheques. They usually pay an interest rate that's higher than a chequeing account, but lower than a money market account. Some savings accounts have a passbook, in which transactions are logged in a small booklet that you keep, while others have a monthly or quarterly statement detailing the transactions. Some savings accounts charge a fee if your balance falls below a specified minimum.

In essence, a savings account is one in which customers save their monthly savings and they are not like the current account. Although the

money is available at any time for the customer to withdraw, but money is not as frequently deposited or withdrawn from it like the current account. Therefore, banks offer a meager interest rate for the money held in this account.

2. Basic Chequeing Accounts

These are sometimes also called current accounts, and they offer a limited set of services at a low cost. The customer as the account owner will be able to perform basic functions, such as cheque writing, but they lack some of the features of more comprehensive accounts. Such accounts usually attract no interest, and they may restrict or impose additional fees for excessive activity, such as writing more than a certain number of cheques per month.

SELF-ASSESSMENT EXERCISE 2

Differentiate between savings account and chequeing account.

3. Interest-Bearing Chequeing Accounts

In contrast to the chequeing accounts, these offer a more comprehensive set of services, but usually at a higher cost. Also, unlike a basic chequeing account, the customers are usually able to write an unlimited number of cheques. Such accounts are sometimes referred to as negotiable order of withdrawal (NOW) accounts. The interest rate often depends on how large the balance in the account is, and most charge a monthly service fee if your balance falls below a preset level.

4. Time Deposit Account

These are also known as certificates of deposit, because the account holder has agreed to keep the money in the account for a specified amount of time, anywhere from three months to six years. Due to the fact that the money will be inaccessible, the account holder is rewarded with a higher interest rate, with the rate increasing as the duration increases. There is a substantial penalty for early withdrawal, so that the holder will be discouraged from embarking on this option but only prepared if you think you might need the money before the time period is over (the maturity date).

5. Deposit Account

Deposit account is one in which the customer deposits a small sum of money (usually a few hundred or thousands) every month. The bank accepts a deposit every month and at the end of the deposit period

(usually 12 months or higher) the bank would return the money deposited with them along with a good interest.

6. Fixed Deposit

Fixed Deposit Account is one in which the customer deposits a big sum of money (Usually a few thousands and upwards. There is actually no limit to the amount of money you can deposit in a FD) for a fixed duration of time at least 3 months or higher. Since you agree to keep the money deposited with the bank for a fixed/agreed upon duration, the bank gives you a very good interest as payment for keeping the deposit. Chequeing Accounts are also called as Current Accounts. A chequeing account is one in which customers keep some money and use it for their day to day transactions. The money in this account does not earn any interest and is available for usage to the customer at all times. These are the 4 main types of accounts provided by banks.

7. Loan Account

This is an account that is normally opened for a customer by a bank at the instance of granting of a loan facility by the bank. The amount of the loan is credited to the customer's current account and similarly debited to the loan account. An arrangement is subsequently made for the customer to repay the loan, usually over a stated period of time, with interest additionally being paid on the outstanding amount.

Loan accounts can be opened only for Approved/Active clients and groups. Fees can be charged to loan accounts in three ways, both at time of account creation and after.

i. Fees are inherited from the product definition. The benefactor can remove one or more of these fees for a particular account. If a fee is removed from an account, it does not affect other accounts.
ii. Predefined fees (not yet associated with the account) can be selected and attached to the account.
iii. Miscellaneous fees (one time charge) can be charged to an account. The user specifies the amount, which is added in the next payment.

SELF-ASSESSMENT EXERCISE 3

Differentiate between deposit account and loan account.

8. Joint Account

This is a bank account that is shared by two or more individuals. Any individual who is a member of the joint account can withdraw from the account and deposit to it. Usually, joint accounts are shared between close relatives such as husbands and wives or business partners. In other words, being a bank or brokerage account that is shared between two or more individuals, joint accounts are most likely to be used between relatives, couples or business partners who have a level of familiarity and trust for each other, as this type of account typically allows anyone named on the account to access funds within it.

Joint accounts are often created in order to avoid probate. If two individuals open a joint account and one of them dies, the other person is entitled to the remaining balance and liable for the debt of that account. Sometimes a temporary joint account is opened by two parties entering into a transaction where one party needs a security for the fulfillment of the transaction and the other party has to pay the sum (deposit), being the security for the other party. Any payment from the joint account, or return of the deposit from the joint account, will only be possible if both parties sign a joint written instruction to the bank. It is not possible that only one of the parties gives instruction for payments of the joint account.

Some banks are not very interested in opening temporary joint accounts, as they are normally used for one transaction only. Therefore, there are specialised parties or companies taking care of such accounts as trustees. A temporary joint account is normally closed after the transaction for which it was opened has been concluded. Temporary joint accounts are used in transactions in which large sums of money are involved as an alternative to letters of credit or escrow accounts.[

Joint accounts can be established on a permanent basis, such as an account between a couple where their salaries are deposited, or may be temporary, such as an account between two parties who contribute funds for a short-term purpose. In the event of a death of one of the account holders, the remaining account holders will have sole access to the funds, as well as any debts associated with the account.

Joint holders of an account are regarded in law as together making up the 'owner.' Any action against them (pertaining to that account) is made against jointly and not individually (severally). Two types of joint accounts are:

(a) Joint-tenancy account

This is the joint account that is owned usually by a married couple in which either owner may individually exercise full rights to make deposits or withdrawals on his or her signatures. In case of either owner's death, the survivor automatically takes the sole control of account assets without probate.

(b) Tenants-in-common account

This is usually owned by two or more business partners or directors in which signatures of all owners are required to exercise certain rights such as making withdrawals. In case of one or more owners' death the other owner(s) may take control of account assets only in accordance with the terms of agreement entered between them before such eventuality. A company account operated by two or more signatories as a means of accounting control or security is not a joint account in the legal sense.

SELF-ASSESSMENT EXERCISE 3

Discuss the nature of a Joint Account, pointing out the various types of this bank account.

3.3 Precautions to Be Taken While Opening Bank Accounts for Customers

Previous to opening an account, the banker should obtain references from respectable 'parties about the proposed customer's integrity and respectability. By allowing a person to open an account without satisfactory reference, the banker could be inviting unpleasant consequences.

The implications of allowing a person to open an account without satisfactory reference involve the following.

1. By obtaining possession of a cheque book, a dishonest person may use it for nefarious purposes.
2. He may happen to be undischarged bankrupt, in which case the banker would be facing serious consequences.
3. The banker may inadvertently allow an overdraft' which can be realized only if the customer is solvent.
4. Omission to make enquiries regarding a customer before opening an account in that person's name is likely to make the banker guilty of negligence. In this connection, the observations made *in Ladbroke Vs Todd* are relevant herein.

According to these observations, the bank acted negligently, for they did not make the enquiries which ordinary, reasonable people should make when opening an account. Furthermore, it was not obligatory upon a bank to make enquiries regarding the respectability of a customer in order to avail itself of the protection given under Section 131 of the Negotiable Instruments Act.

Nevertheless, in the more recent case of *Union of India Vs National Overseas and Grindlays Bank (1978),* the Court observed;

The modem banking requires that a constituent should either be known to the banker or should be properly introduced. The bank owed a duty to make enquiries directed to discover whether a new constituent might use the account for any fraudulent purposes The underlying object of the bank insisting on producing reliable reference is only to find out, if possible, whether the new constituent is a genuine party or an impersonator or a fraudulent rogue....

...(however) the burden of establishing good faith and absence of negligence is on the defendant. The bank has to establish that they acted without negligence not only in the receipt of the payment of the cheque amount but even earlier at the time of opening the account.

In short, the safer course for the banker would be to obtain references for the respectability and integrity of a proposed customer before opening an account. As a matter of fact, it is customary for the banks in Nigeria to insist that it is only customers whose current bank accounts operative in the last six months that can be used as referees for opening a new account.

3.4 Special Types of Customers

1. Lunatics

A contract by a lunatic is void, although he can enter into valid contracts during lucid intervals. Hence a banker should not knowingly open an account in the name of a person of unsound mind. For instance, if a lunatic draws a cheque and the party taking the instrument is aware of the incapacity, the cheque is unenforceable against the Person so drawing. However, a banker honouring such a cheque in good faith and without negligence can debit it to the customer's account. If, on the other hand, the banker has received notice of the customer's lunacy, or If he has knowledge of it, he will be liable for all cheques honoured by him. Therefore, as soon as the banker comes to know of the lunacy of the customer he must an operations on the account.

2. Drunkards

A sane man who is delirious from fever or who is so drunk that he cannot understand the terms of a contract or form a rational judgment about its effects on his interest, cannot contract while such disorientation or drunkenness lasts. Thus a contract by a drunken person is void. But it should be remembered that ordinary drunkenness is not sufficient to make a contract void. He must be so intoxicated as to be incapable of understanding the nature and effect of the contract on his interests. Therefore, when a customer presents a cheque across the counter when drunk, the banker, to be on the safe side, should see that the payment is witnessed.

3. Undercharged bankrupts

The banker should not open an account in the name of an undischarged bankrupt. If he finds that a customer is an undischarged bankrupt, he must stop operations on the account at once and inform the Official Assignee of it.

4. Minors

Any person who is under the age of 18 years is a minor. However, if a guardian has been appointed before attaining the age of 18 years, the age of majority is extended to the date when he completes 21 years of age. A minor is not competent to contract and all his contracts are void.

The banker runs no risk in opening an account in the name of a minor so long as the account is kept in credit. But if the banker grants an overdraft to a minor, the latter cannot be sued for repayment since the transaction is void. Furthermore, the banker cannot avail himself of any security lodged by the minor to secure his debt. So it is advisable to open an account in the name of parent or guardian. In the absence of such an arrangement, the banker should neither allow an overdraft nor allow the minor to draw against uncleared items.

A minor may act as an agent, but the banker should obtain written instructions from the principal regarding the power. A minor may also be a partner; but he cannot be held personally liable for the debts of the partnership firm.

A minor is not bound by a negotiable instrument given by him. This is true even if the instrument was given by the minor for necessaries supplied to him. But of course, the supplier may sue on the original consideration to be reimbursed from the minor's assets for necessaries supplied. If a minor makes, draws or endorses a negotiable instrument,

the holder will not be entitled to enforce it against him, although the holder can proceed against all the other parties except the minor. A minor can become payee by process of law and enforce payment of the amount of a negotiable instrument. Execution of a joint promissory note by a minor will not affect the liability of the co-executants.

5. Married women

A banker may open an account in the name of a married woman. She can enter into contracts and bind her separate estate. However, in the case of an overdraft granted to a married woman, the banker has no remedy against her unless she has separate estate. The husband too cannot be made liable for such debts unless the banker has obtained his personal guarantee, or the loan has been granted for the *purpose* of her necessaries of life. Further, the banker has no personal remedy against a married woman.

6. Agents

A banker may open an account in the name of a person who is acting as the agent of another person. The account should be considered as the personal account of the agent. The banker has no authority to question his power to deal with the funds in the account unless it becomes obvious that the agent is guilty of breach of trust.

However if a person is only authorized to act behalf of the principal, the banker should verify the authorization. If he has been appointed under a power of attorney, the banker should carefully examine the letter of attorney to confirm the powers conferred by the document on the ag[e]nt. On receiving notice of the principal's death, insanity or bankruptcy, the banker must suspend all operations on the account.

7. Executors and Administrators

Bankers generally open executorship or administration account before getting probate or letter of administration in order to provide funds for the estate duty, because in the absence of payment of this duty, probate or letter of administration will not be granted. However, before advancing money, the banker should satisfy himself that the persons applying for the accommodation are the proper persons. Further, since a banker cannot hold securities deposited by the deceased against such an advance *(Farhall Vs Far/tall),* a personal undertaking must be taken m the executors or administrators, making them jointly and severally liable in case of default to repay the advance from the assets of the deceased. The banker should not transfer any credit balance on the account of the deceased in the name of the executors or administrators until the probate

or letter of administration has been produced. On producing the probate or letter of administration. the banker should make note of any details that may affect the account.

A banker opening an account for executors or administrators should see that they are not unduly prolonging the realization of the business, unless the in the Will authorizes them to continue the business. Otherwise, the banker may be held liable for breach of trust. Even when the Will authorizes the continuation of the business, the banker should see that all the creditors of the deceased have been satisfied, or else he should see that they have given their assent before granting any advance In case of failure, the creditors who have not given their assent may claim payment of their debts in priority to the bank.

Before allowing the exe cutors/administrators to operate on the account, it is desirable to obtain a mandate, signed by all the executors/administrators, laying down the manner in which the bills and cheques are to be signed and endorsed, and holding all of them jointly and severally liable for any overdraft It may be pointed out here that any one executor can effectively countermand payment of a cheque even where all executors are required to *sign* cheques together. So also, where the mandate authorizes either of two executors to operations on the account one of them can stop payment of a cheque signed by his co-executor.

Further executors/administrators, except in special circumstances, have no power to delegate their authority to operate on the account to any outside parties. Hence a banker should not accept such a mandate.

On the death of an executor/administrator, his powers are vested in his co-executors/co-administrators, unless otherwise provided for in the Will. If he is the sole executor, his duties are vested in an executor whom he may nominate. But if he is the sole administrator, a fresh letter of administration must be applied for.

The banker should be careful to stop operations 011 an overdrawn account as soon as he receives notice of the death of an executor/administrator, in case the overdraft is secured by the personal liability of the deceased.

In case of bankruptcy of an executor/administrator, ' the banker need not stop since it does not terminate his appointment. In case of lunacy of an executor/administrator, his authority is terminated, and the banker should not honour cheques signed by such an executor/administrator without the consent of the remaining executors/administrators.

8. Partnership

While opening an account in the name of a partnership firm, the banker should obtain a mandate signed by all the partners containing information regarding the nature of the firm's business, the names and addresses of all the partners, the names and addresses of those who are authorized to operate on the account together with their specimen signatures, and the extent of their authority. It is also advisable to examine the partnership deed to note whether there are any special regulations regarding the bank account, borrowing powers, etc. Where a third party is authorized to operate the account, the mandate should clearly state whether the third party has the authority to overdraw the account.

Any partner has an implied power to stop payment of a cheque drawn on the firm's account and the banker is bound to comply with the instruction of the partner. So also, any one or more partners may cancel the authority given to operate on the account, and in that case, the banker should not honour cheques drawn by such an authority. Every partner in a commercial partnership (trading Inn) has implied authority to bind the firm by making, drawing, signing, endorsing, accepting, negotiating and discounting negotiable instruments in the name, and on account of, the partnership. He also has authority to borrow money. However, the banker should not honour cheques or other instruments signed by a partner whom the bank mandate does not authorize to sign on behalf of the firm. The power of a partner to borrow is also dependent on the instructions in the mandate.

A partner in a non-trading firm has no implied authority to borrow, to make or to issue negotiable instruments, although he may sign cheques. Therefore, the banker should get the signature of all the partners in a non-trading firm for all transactions involving advances to the firm, discounting or the negotiation of bills of exchange. Another implied authority of a partner in a commercial partnership is his power to pledge the firm's properties. But this implied power is confined to those transactions incidental to the firm's ordinary course of business. Hence, the safe course for the banker to take would be to get the assent of all the partners.

A partner has no implied power to bind his co-partners by deed. Therefore, the banker should see that he gets the assent of all the partners when immovable properties of the firm are mortgaged as otherwise, the banker will *get* only an equitable title and not a valid legal title.

It may be mentioned here that the implied authority of a partner to bind the firm does not extend to guarantees. A partner cannot bind the firm by giving a guarantee on behalf of the firm, unless it is customary for that firm. A partner cannot bind the firm by opening an account in his own name on behalf of the firm unless he is expressly authorized to do so by all the partners. The banker should not accept cheques payable to the firm for the credit of the private account of a partner. When such a cheque is presented, the banker should make enquiries. Failure to do this will deprive the banker of his statutory protection.

When a new partner is admitted to the firm, the banker need not stop the account, provided the account shows a credit balance. However, the banker should obtain a new mandate signed by all the partners, including the new partner. But when the partnership account shows a debit balance, the banker should stop the old account and open a new account. A new mandate should also be obtained. The banker may take an agreement signed by the new partner undertaking liability in respect of the outstanding debts of the firm.

When one of the partners dies, the partnership firm stands dissolved. The banker can, however, continue the account. The remaining partners are entitled to any balance on the partnership account. They can give the banker a valid discharge for it. In case the partnership account shows a debit balance, the account should be stopped to fix the liability of the deceased. The rule applies even when cheques are signed by the deceased partner.

In the event of insolvency of a partner, the solvent partners have a right to operate the partnership account in connection with the winding-up of the business. However, if the partnership firm is indebted to the bank, the account should be stopped and a new account should be opened in order to avoid the *Rule in Clayton's Case*. The banker should not honour cheques drawn by the insolvent partner. Cheques drawn before adjudging hi insolvent may be honoured by the banker. However, it is advisable to obtain the confirmation of the other partners.

In case of retirement of a partner, the retiring partner will continue to be liable to the banker till the banker is served with a notice of the retirement. On receiving such a notice, the banker should take a new mandate from the continuing partners. If the partnership account shows a debit balance, the account should be stopped in order to avoid the application of the *Rule in Clayton's Case*.

In case of lunacy of a partner, the partnership firm does not stand dissolved. However, upon the application of a fellow partner, the Court may order a dissolution. On such a dissolution, the banker may allow the

other partners to continue the account if it shows a credit balance. If, on the other hand, the account shows a debit balance, the banker should stop the account.

Alterations in the constitution of a firm will affect any charges which may have been given on the partnership property. Therefore, the banker should obtain a new mortgage deed signed by all the new and continuing partners.

9. Joint Stock Companies

While opening an account in the name of a joint stock company, the banker should ascertain the powers of its directors and managers from the Articles and Memorandum of Association. The banker should also examine the company's Certificate to Commence Business. He should further ask for an authenticated copy of the resolution appointing him as the banker. This should be accompanied by a mandate in the usual form, containing information such as the names of the persons authorized to sign cheques and other documents, their specimen signatures, the extent of their authority, etc.

The company should be instructed to inform the banker of any variation in the appointment of directors and other officers concerned. Such notification should be accompanied by a duly signed copy of the resolution effecting such a change.

A trading company has implied powers to borrow it and pledge the property of the company to such an extent as may be reasonable and necessary for carrying out the objects stated in the Objects Clause of the e Memorandum. If the Memorandum limits the borrowing powers to a fixed amount, the banker should strictly adhere to it. The banker also should see whether or not the Articles of Association impose any limitation on the directors' powers to pledge the property, or to borrow money. In the case of a non-trading company, borrowing powers would be expressly given in the Memorandum of Association.

A banker lending money need not enquire about the purpose for which the company is taking the loan. If the loan is misapplied, it cannot be avoided, provided the banker has acted in good faith and without knowledge of the intended misapplication. However, where the banker is asked to lend money for a purpose outside the company's powers, he should not grant it.

On receiving notice of the passing of a resolution to wind up the company, or of the presentation of a petition to wind up the company, the banker should immediately suspend all operations on the account.

10. Local authorities

The banker should be very careful while opening the account of local authorities. Local authorities are trustees of the public funds which they control. Hence the banker should exercise as much care as he would do with any other trust account.

The relevant statute creating the authority should be examined to ascertain the powers given to it. The banker should keep himself within the strict limits laid therein.

11. Trust Accounts

Prior to opening an account in the name of a trust, the banker should carefully examine the Trust Deed and ascertain matters such as the power of the trustees to delegate their powers to any one or more of them, their power to borrow money and the manner of operating on the account in case of death or insolvency of a trustee. It may be noted here that unless the Trust Deed gives authority to the trustees to delegate their powers, they cannot do so. Consequently, in the absence of *an* express provision in the Trust Deed to the contrary, the banker should honour only these cheques that are signed by all the trustees.

Even when an account is opened without describing it as a trust account, and the banker comes to know that it is a trust account, he should not allow the customer to draw money for a purpose obviously inconsistent with the customer's duty as a trustee. However, this does not mean that the banker should act as a detective.

Where a customer has more than one account, the banker need not necessarily presume that one of them is a trust account. In some cases, the very title of the account may indicate that it is a trust account. For instance, the opening of an account under the title is clearly a trust account. In such cases, if the banker has information that the account is a trust account, he cannot escape liability merely on the ground that there is no indication of the fact in the title of the account. For instance, the opening of an account under a title does not describe the account as a trust account. It only shows that the account is a private account with reference to a particular transaction.

However, the banker should pay regard to the circumstances, or to any information showing that the account is a trust account. Furthermore, the opening o account under a title does not necessarily describe the account as a trust account; it may mean an account belonging to the name as ascribed to the title consisting of funds brought in by the holders. However, if the title means that account has been opened by Quest to be

drawn on by Quotex, then it is a trust account.

It was held in *John vs Dodwell* that if a customer had one bank account in his personal name and another in the trust name, a transfer of money from the trust account to the personal account should put the banker on enquiry. This is particularly important when the transferee account happens to be overdrawn. The banker could be held liable for breach of trust; if it can be proved that he derived some benefit out of t transfer.

The banker should not credit the trustee's private account with cheques drawn in favour of the trust. Again, the banker is not entitled to use his right of set-off between the trustee's private account and the trust account. But if he has no notice of the character of the accounts, he may exercise his right of set-off. Further, the banker should not grant an advance against trust securities on a trustee's private account.

Except the Trust Deed gives express power to the trustee to borrow and pledge trust property, the banker should note that the trustee is not entitled to borrow money or give any security. But if the Deed gives express power to the trustee to borrow money by mortgaging trust property, he may do so.

On receipt of notice of the death of one of the trustees, the banker should ascertain from the Trust Deed whether or not the surviving trustees are entitled to act without the appointment of a new trustee. If a new trustee is required, the banker should stop all operations on the account until a new trustee is appointed.

Where a trustee becomes an insolvent, it does not involve the trust property. The trust property belongs to the beneficiaries, and the private creditors of the trustee have no right to claim it. The trustee's right to deal with trust property, for the purpose of trusteeship, is also not affected unless the Trust Deed provides othe[r]wise. On receipt of the notice of the trust[e]e, operations on the account by that trustee should be suspended.

12. Unincorporated Bodies

While opening an account in the name of unincorporated bodies like clubs, committees' associations, etc., the banker should ask for an authenticated copy of the resolution appointing him as the banker. A mandate containing the names of authorized to operate on the account along with their specimen signatures should also be obtained. Since it has no legal personality, it should be remembered that an unincorporated body cannot be held responsible for any liabilities incurred by its officials. Relatedly, the persons authorized to sign cheques cannot be

held personally liability for any overdraft in case, in signing the cheques, they clearly indicate that they are acting in their representative capacity and not in their individual capacity. Nevertheless, if the account is opened and operated in the style Koleosho A/C, then the banker is entitled to consider it as a personal account of Koleosho.

13. Joint Accounts

When opening an account in the joint names of two or more persons, the banker should get written instructions signed by all the account holders regarding the names of the persons authorized to operate on the account and the extent of their authority. In the absence of such instructions, the banker should honour only those cheques which are signed by all the account holders.

The authority to operate on the account may be given to an outsider. It may, however, be noted here that one of the joint account holders authorized to operate on the account does not have the power to delegate his power to an outsider. The authority given to any person to operate on the account may be revoked by any joint account holder. When the banker is given notice of such revocation, he should act accordingly. Death, bankruptcy or insanity of the person authorized to operate on the account automatically revokes the authority. Similarly, the authority is automatically revoked by the death, bankruptcy or insanity of the person giving the authority.

Until recently, it was considered that an innocent joint account holder had no remedy against a bank for breach of mandate instructions caused by the forgery of another joint account holder. This was based on the decision in *Brewer Vs Westminster Bank Ltd.* In this case, the co-holder of a joint account had forged the plaintiff's signature. It was held that both parties to the joint account had to be parties to the proceedings. The actual plaintiff would thereby be affected by the misconduct of the deemed co-plaintiff and also by the rule that a party could not rely on his own misconduct. The position now, however, appears to be different in view of the decision in *Caralin Vs Cyprus Finance Corporation (London) Ltd.*

According to the facts of above case, a joint account was opened by a husband and wife and the mandate clearly specified "both to sign". The bank *negligently* allowed the husband to transfer funds from the joint account to an account in his personal name without the wife signing the withdrawal instruction. Thereupon the wife proceeded against the bank for breach of mandate instructions and for restoration of funds in the joint account. The bank argued that the contract with the bank relating to

the joint account was with both the wife and the husband, that neither of them had any separate rights and the wife could not sue by herself. This argument was not accepted and it was held that the bank did not only have an obligation to the account holders jointly, but it also had an independent obligation to each of them that it would not honour withdrawal instructions unless signed by both joint account holders.

It is always advisable for the banker to see that the joint account mandate deals with the question of survivorship. However, as a general rule, it may be stated that the survivor/s are entitled to any balance in the joint account. On receiving notice of the death of a joint account holder, the banker should not honour cheques bearing the signature of the deceased, although there is no objection in honouring cheques signed by all the surviving parties. On the death of all the joint account holders, the balance, if any, is payable to the legal representatives of the person who dies last.

When the joint account shows a debit balance, the banker can proceed against the deceased only if the mandate includes an undertaking by the parties to be jointly and severally liable. In the absence of such a provision, the estate of the deceased becomes free from liability. If the banker has the power to claim against the estate of the deceased, he should immediately suspend all operations on the account on the death of the party. Otherwise, the *Rule in Clayton's Case* will operate.

In the case of lunacy of a joint account holder, the banker should stop operations on the account until he gets joint instructions from the other account holders and the Receiver or Committee in Lunacy.

On receipt of a notice of insolvency of a joint account holder, pending joint instructions from the solvent account holders and the Trustee in Insolvency the account should be stopped. As in the case of the death of one or more joint account holders, here too the banker can proceed against the estate of the insolvent only if the mandate includes an undertaking by the parties to be jointly and severally liable.

As regards a joint account in the name of a husband and wife, the balance cannot be claimed by the widow, unless it can be proved that the husband opened *the* account with the deliberate intention of making a provision for his wife, as was held in *Marshall Vs Coutwell* and *Foley Vs Foley* If the banker has been given express instructions to pay the balance to the survivor, his position would be more secure. So it is always advisable for the banker to take written instructions regarding the disposal of the balance in case of death of either party. However, if the wife dies first, and even *the* intention of the parties is not clear, the banker is justified in paying the balance to the husband.

14. Fixed Deposits

In addition to accepting money on current/savings bank accounts, bankers receive money on deposit accounts undertaking to repay the amounts on the expiry of a specified period, or subject to a notice. Bankers generally prefer deposits which are repayable after the expiry of a specified period. Such deposits are known as "Fixed Deposits".

When a person deposits money with the banker on a fixed deposit, a 'Deposit Receipt' is given to him by way of acknowledgment for the amount deposited. This document is usually marked ¯not negotiable", which means that it cannot be transferred by mere endorsement' and delivery. It was held *in Evans Vs National Provincial Bank of England* that payment to a person wrongfully dealing with even a signed deposit receipt was no discharge to the bank, unless the depositor was estopped by his conduct from disputing such payment.

However, the deposit receipt can be assigned provided due notice of assignment is given to the banker. But it may be noted here that the banker would *be* entitled to recover from the deposit amount any motley owing to him from the depositor at the time of receipt of such a notice.

In some cases, the banker may make the signing of the deposit receipt a prerequisite to the withdrawal of money. Nevertheless, the banker cannot refuse payment in case of loss of deposit receipt. He can pay the amount safely after obtaining an ordinary indemnity from the customer. It may be noted here that the deposit receipt, being a non-negotiable instrument, will not get a valid title for any holder other than the customer.

A deposit receipt has been held to be a good subject of *donation mortis causa* (i.e., a gift made in contemplation of death and to take effect only in the event of death).

A depositor is not legally entitled to draw cheques against fixed deposits. But in the case of deposit accounts repayable on demand, there is a conflict of judicial opinions. In *Hopkins* vs *Abbot, it* was held that cheques could be drawn against deposit accounts repayable on demand. On the other hand, according to Dr. H.L. Hart and Sir John Paget, a depositor is probably not entitled to draw cheques against deposit accounts repayable on demand. Some banks have a cheque form printed on the back of the deposit receipt. This, however, does not change the nature of the deposit account.

A fixed deposit is attachable by a garnishee order since the order attaches funds due or accruing due.

In case of insolvency of a depositor, the amount should go to the Official Assignee. In case of death of the depositor, the amount should go to his personal representatives.

Fixed deposit accounts may be opened in the name of minors and they can give a valid discharge for the deposit amount repaid to them.

Fixed deposit accounts may be opened in the name of joint parties. Here, all the parties should combine in withdrawal. In the case of death of one or more of the parties, the property passes on to the survivor/s. When the deposit is in the joint names of husband and wife, as mentioned earlier, this rule does not apply. On the death of the husband, the property does not pass on to the widow unless it can be proved that the husband opened the account with the deliberate intention of making a provision for his wife in case of his untimely death. In *Nagarajamma vs State Bank of India,* it was held that a fixed deposit in the joint names of a husband and wife payable to either or survivor would not, on the death of the husband, constitute a gift by the husband to his wife. The decision was followed in *Guru Datta vs Ram Dana.* If, however, the wife dies first, in the absence of any express instruction to the contrary, the property passes on to the husband.

Deposit receipts given by bankers are exempted from stamp duty

In the case of a fixed deposit account, the law of limitation begins to run from the expiry of the fixed period. If the account is a deposit account repayable after the expiry of a specified period's notice of withdrawal, the law of limitation begins to operate immediately after the money is due to be repaid. If the account is a deposit account repayable on demand, the law begins to operate from the date when a demand for repayment has been made by the depositor.

SELF-ASSESSMENT EXERCISE 4

Mention special categories of bank customers and outline the precautions to be adopted in dealing with opening of their accounts.

4.0 CONCLUSION

Bank accounts opened and maintained by the customers form the basis of banker-customer relationship. There are many types of bank accounts that customers do have with their banks. Some of such accounts are interest bearing accounts while some other ones attract charges – commission on turnover - by the banks. Some bank accounts are normally opened jointly for some parties such as husbands and wives

while some are maintained by partners in partnership businesses. The other type is the account that banks require their customers to open when they are granted loan facilities. There are fundamental precautions to b taken into considerations when opening and dealing with accounts of special categories of bank customers.

5.0 SUMMARY

We have discussed, in this study unit, various accounts which customers can open and maintain with the banks,. Issues discussed include meaning of bank account and types of bank account of customers, which snowballed into analysis of bank accounts such as: savings accounts; basic chequeing accounts; interest-bearing chequeing accounts; time deposit account; deposit account; fixed deposit; loan account; joint account; precautions to be taken while opening bank accounts for customers; and special types of customers. In the next study unit, we shall discuss specialized bank accounts of customers.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Different between savings account and chequeing account.
2. Discuss the nature of a joint account, pointing out the various types of this bank account.

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UNIT 5 SPECIALISE BANK ACCOUNTS OF CUSTOMERS

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we discussed some bank accounts of customers in which various types of such accounts were identified and analyzed. In this study unit, we shall identify the various forms of specialized bank accounts that banks do maintain for their customers. Such specialize forms of bank accounts, therefore, constitute the subject of discussion in this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the meaning of money market account
- explain tax-free saving account
- discuss special tax-free saving account.

3.0 MAIN CONTENT

3.1 Money Market Account

A money market account (MMA) or money market deposit account is a financial account that pays interest based on current interest rates in the money markets. Essentially, therefore, it is an account that typically has a relatively high rate of interest and requires a higher minimum balance in order to qualify for earning interest or avoiding monthly fees. It is a kind of investment strategy which is similar to, and meant to compete with, a money market fund offered by a brokerage. Nevertheless, these types of account are not related.

In other words, the account is an interest-bearing type of account that typically pays a higher interest rate than a savings account, but it provides the account holder with limited cheque-writing facility. Therefore, a money market account offers the account holder some benefits which are typical like those of current and savings accounts. However, this type of account is likely to require a higher balance than a savings account, and it is normally insured just like other bank accounts. Money market accounts are widely available, and are maintained by some banks and other financial institutions. They are able to offer a higher interest rate by requiring a higher minimum balance, and by placing restrictions on the number of withdrawals the account holder may take over a given period of time. Such restriction makes these accounts less liquid than a current account. Nevertheless, they are more liquid than bonds.

Just like the interest that is being earned on current and savings accounts, the interest earned on a money market account is subject to taxes. The account holders do not have to buy shares in a money market account, as interest being earned on deposits in these accounts is similar to the interest earned on current and savings accounts. The banks that offer such money market accounts normally take a low-risk approach when investing their deposits in financial instruments such as certificates of deposit, government securities, and commercial papers.

SELF-ASSESSMENT EXERCISE 1

Explain the nature of money market account.

3.2 Tax-Free Savings Account

The Tax-Free Savings Account is an account that is characterized by tax benefits for saving in country such as Canada. The benefits such as investment income, including capital gains and dividends and, as accrued to this type of account is not subject to taxes, even at the time of withdrawal. Contributions to tax-free savings account are not deductible for income tax purposes.

This account is regarded an investment option for Canadian residents that are 18 years and above who are interested in maintaining such a saving account. Normally, the account-holder can contribute a certain amount every year. The income earned on contributions to such accounts is not subject to taxes. The flexible structure inherent in this type of account allows the holder to withdraw money from the account at any time, free of taxes. This implies that the account-holder is at liberty to withdraw any amount out of the balance in the account, and is devoid of charges such as capital gains and or withdrawal taxes.

Another interesting feature of this account is its mechanism in the design which involves the carry-over aspect. This implies that any unused space under the amount specified as cap can be carried forward to subsequent years, without any upward limit. In Canada where this is the practice, The specified annual contribution limit is normally indexed to the Consumer Price Index (CPI), in some multiple increments; this is employed as mechanism in order to account for inflation.

In essence, the Tax-Free Savings Account is an account that is flexible, registered, general-purpose savings medium that allows the Canadians to earn tax-free investment income, which is more easily employed to meet lifetime savings needs. The account particularly complements existing registered savings plans like the Registered Retirement Savings Plans (RRSP) and the Registered Education Savings Plans (RESP) in Canada.

The mechanism of the Tax-Free Savings Account functions as follows

1. The starting age for opening of and contributions to such an account is eighteen (18) years.
2. There's no maximum age limit to contributing to such an account; a customer can continue to invest even after the age of 71.
3. Investors can contribute a maximum of $5,500 in the year 2014 as defined by regulation, which has been changing on yearly basis.
4. When a customer has not contributed in the past, or did not meet maximum contributions in any given year, he/she can catch up on unused contributions, up to the $31,000 limit as of this calendar year.
   The ideal way to keep track of a customer's unused contribution is to check out his/her notice of assessment.
5. A customer is normally advised to be careful not to over-contribute or he/she will incur tax penalties equal to 1% of the highest excess amount in the month and for each month of such excess contribution.
6. A customer can withdraw money at any time without penalty or tax consequences. Nevertheless, he/she can't re-contribute that amount in the same calendar year. In the event that a customer only needs the funds for a short time and plan to replace them quickly, the best strategy is to make the withdrawal late in the calendar year so he/she can re-contribute from first day the month in the following year.
7. Withdrawals from the account do not impact any government benefits or assistance programs such as child tax benefits, old age security or other guaranteed income supplements. This means

low-income earners can generate tax-free income without it affecting their support.

8. The account is not just a cash account. It can be structured so the customer can invest in various media such as, bonds, mutual funds, stocks and exchange-traded funds, among other options.
9. Deductions from the account are not tax deductible. However, the customer can double up on tax-free income generation by opening a second account in the spouse's name.
10. For those on a limited budget, the best way to keep up with contributions is to set up an automatic monthly withdrawal plan.

SELF-ASSESSMENT EXERCISE 2

Explain the nature of Tax-Free Savings Account.

3.3 Tax-Exempted Special Savings Account

This type of account is being operated in the United Kingdom. The Tax-Exempted Special Savings Account (TESSA) scheme was introduced in 1990 and operative in 1991 in the UK which is meant to be a low-risk complement to the personal equity plan designed to be attractive to a wider range of savers. An individual age of 18 years and above was able to open a Tax-Exempted Special Savings Account (TESSA) with a bank, building society other financial institution from 1 January 1991 to 5 April 1999.

A specific requirement was the presentation of the applicant's national insurance number, facilitating identification to taxation, for the purpose of ensuring only one TESSA (tax-free) account investment could be operated by the individual per year. Interest on the TESSA was free from UK income tax. The favourable tax treatment of a TESSA lasted for 5 years, and it was possible to invest up to £9,000, with a maximum investment of £3,000 invested in the first year and £1,800 in each of the second to fifth years. Nevertheless, if the maximum was invested in the first four years, only £600 could be added in the fifth year. Withdrawals were permitted within the first 5 years: tax relief was clawed back if any of the invested capital was taken out; withdrawals of interest did not trigger a claw back of the tax relief.

A follow-on Tax-Exempted Special Savings Accounts were introduced in 1995 to permit all of the capital, but not the tax-free interest, from an original TESSA to be 'rolled over' into a new TESSA. Other than permitting all of the capital in the original account to be invested in the first year, which could easily exceed the usual £3,000 first-year limit, a 'follow-on' Tax-Exempted Special Savings Account was subject to the same conditions as any other TESSA.

The Tax-Exempted Special Savings Accounts (TESSAs) were replaced from 1999 by Individual Savings Accounts (ISAs). The final TESSAs matured on 5 April 2004, but the original capital, but not the tax-free interest, could again be 'rolled over' into a new notional income tax-free investment through the use of a Tax-Exempted Special Savings Account only Individual Savings Account (TOISA). The account TOISA was a form of cash Individual Savings Account which can be opened using either capital that was originally invested in a TESSA and that has not been withdrawn, or with funds transferred from another TOISA.

From 6 April 2007 there was no practical difference between TOISAs and cash ISAs and transfers into cash ISAs have been permitted. On 5 April 2008, TOISAs ceased being legally distinct and are now completely interchangeable with cash Individual Savings Account.

The rules governing tax-exempt savings accounts can be summed up as strict but simple. By observing the inherent rules governing the TESSA and the interest being earned by the fund of the savers become entirely tax free. This implies that by breaking the rules the tax authority would call for its share.

Basically, most of the rule-following is normally done by the financial institution that operates the account. So by trying to deposit more than the maximum allowed, the excess will be rejected. Nevertheless, the differences between the rules on Tax-Exempted Special Savings Accounts and those governing personal equity plans need to be properly understood.

There are strict limits to the amount you can invest in your TESSA. If it is your first Account, you can deposit the sum of £3,000 in year one and then increase it to pounds 1,800 in each of the following four years, to a total of pounds £9,000.

Furthermore, at the end of the five-year term you can open a follow-up TESSA and pay in all the capital, but not the interest, from your first account. If that is the full £9,000 you cannot make any further deposits until the end of the second five-year term. However, if the total deposits (excluding the interest) in your first Tessa come to less than £3,000 you can top up a second TESSA to this £3,000 level in the first year.

In order to allow time for financial planning, the rules allow up to six months between the date your first TESSA matures and the start of a second TESSA. This allows you to roll over the full £9,000. However, you cannot touch the capital during the life of a TESSA without forfeiting the tax-free status, you can take some of the interest but

subject to the limit of the amount you would have earned if the account had been an ordinary taxable type.

Assuming you have £1,000 in your TESSA and the interest rate is 5 per cent, you will earn £50 interest, credited to your account. On an ordinary savings account, £12 of this would be taken in tax, that is, 24 per cent of £50, thus leaving you with £38. Basically, since this is a tax-exempt account, no money is handed over to the Exchequer. Instead, you can draw the £38, retaining the £12 in the account until it is five years.

SELF-ASSESSMENT EXERCISE 3

Explain briefly the nature of Tax-Exempted Savings Account.

4.0 CONCLUSION

There are some specialize bank accounts that can be opened and maintained by the customers which form part of the basis of banker-customer relationship. These specialize banks may not be tenable in Nigeria but they are very much in use in other countries such as US and UK. Such accounts include money market account, tax-free savings account, and special tax-free savings account, which enjoy distinct privileges as conferred on the customers that maintain them with their bankers.

5.0 SUMMARY

In this course of the analysis on bank accounts, we have discussed, in this study unit, various types of specialize accounts which customers can open and maintain with the commercial banks and building societies in US and UK. Such discussions include: Money Market Account; Tax-Free Savings Account; and Special Tax-Free Savings Account. In the next study unit, we shall discuss negotiable instruments: cheques, promissory notes and bills of exchange.

6.0 TUTOR-MARKED ASSIGNMENT

Enumerate three types of special accounts that customers can open and maintain with their banks.

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UNIT 6 NEGOTIABLE INSTRUMENTS AND CHEQUES

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed some forms of specialize bank accounts of customers in which various types of such accounts were identified and analyzed. In this study unit, we shall discuss the nature of negotiable instruments. In the course of this analysis, we shall also espouse on instrument such as cheques which constitutes a basic form of negotiable instruments.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of negotiable instruments
- explain the nature of cheque as a form of negotiable instruments.

3.0 MAIN CONTENT

3.1 Nature of Negotiable Instruments

3.1.1 Meaning of Negotiable Instrument

In simple terms, a negotiable instrument is a document guaranteeing the payment of a specific amount of money, either on demand, or at a set time with the payer named on the negotiable instrument. This implies that it is a document contemplated by a contract, which warrants the payment of money without condition which may be paid on demand or at a future date.

In another perspective, a negotiable instrument is a written instrument, signed by the maker or drawer of the instrument, that contains an unconditional promise or order to pay an exact sum of money (with or without interest in a specified amount or at a specified rate) on demand or at an exact future time to a specific person, or to order, or to its bearer.

In other words, negotiable instruments are written orders or unconditional promises to pay a fixed sum of money on demand or at a certain time. Promissory notes, bills of exchange, cheques, drafts, and certificates of deposit are all examples of negotiable instruments. Negotiable instruments may be transferred from one person to another, who is known as a holder in due course. Upon transfer, also called negotiation of the instrument, the holder in due course obtains full legal title to the instrument. Negotiable instruments may be transferred by delivery or by endorsement and delivery.

Since money is promised to be paid, the instrument itself can be used by the holder in due course as a store of value. The instrument can be transferred to a third party and it is the holder of the instrument who will ultimately get paid by the payer on the instrument. Transfers can happen at less than the face value of the instrument and this is known as discounting, this may happen for example if there is doubt about the payer's ability to pay. Due to the nature of the negotiable instrument as store of value, most countries passed laws specifically related to negotiable instruments.

One type of negotiable instrument, called a promissory note, involves only two parties, the maker of the note and the payee, or the party to whom the note is payable. With a promissory note, the maker promises to pay a certain amount to the payee. Another type of negotiable instrument, called a bill of exchange, involves three parties. The party who drafts the bill of exchange is known as the drawer. The party who is

called on to make payment is known as the drawee, and the party to whom payment is to be made is known as the payee. A cheque is an example of a bill of exchange, where the individual or business writing the cheque is the drawer, the bank is the drawee, and the person or business to whom the cheque is made out is the payee.

To be valid, a negotiable instrument must meet four requirements. First, it must be in writing and signed by the maker or drawee. Second, it must contain an unconditional promise (promissory note) or order (bill of exchange) to pay a certain sum of money and no other promise except as authorized by the Uniform Commercial Code (UCC). Third, it must be payable on demand or at a definite time. Finally, it must be payable either to order or to bearer.

A negotiable instrument is said to be dishonored when, upon presentation, payment or acceptance has been refused. To qualify as a holder in due course, an individual or business must have taken the negotiable instrument before it was overdue and without notice that it had been previously dishonored, if such was the case. The negotiable instrument must also be complete and regular upon its face; that is, all of the necessary information must be present. The holder must also take the instrument in good faith and for value. At the time it was negotiated, the holder in due course must have had no notice of an infirmity in the instrument or a defect in the title of the person negotiating it.

If these conditions are met, then the holder in due course generally holds the instrument free from any defect of title of prior parties involved with the instrument. The holder in due course may enforce payment of the instrument for the full amount against all parties liable thereon, free from any defenses available to prior parties among themselves.

Negotiable instruments may be endorsed in various ways, and some negotiable instruments do not require any endorsement. If a negotiable instrument is a bearer instrument, then it may be negotiated by simply delivering it from one person to another with no endorsement required. Such negotiable instruments typically have a blank endorsement consisting of a person's name only. If the negotiable instrument is an order instrument, then the payee must first endorse it and deliver it before negotiation is complete. For example, if the instrument says, "Pay to the order of Jane Smith," then it is an order instrument and Jane Smith must endorse it and then deliver it to the payer or drawee.

Endorsements such as "Pay to the order of Jane Smith" are known as special endorsements and have the effect of making the instrument an order instrument rather than a bearer instrument. Restrictive endorsements ("Pay to Jane Smith only") and qualified endorsements

("Pay without recourse to the order of Jane Smith") also have the effect of requiring the payee to endorse the negotiable instrument. Qualified endorsements also affect the nature of implied warranties associated with endorsement.

Under the UCC, an unqualified endorser who receives payment or consideration for a negotiable instrument provides a series of implied warranties to the transferee and any subsequent holder in due course. An unqualified endorser warranties that he or she has good title to the instrument or represents a person with title, and that the transfer is otherwise rightful. The endorser also warranties that all signatures are genuine or authorized, that the instrument has not been materially altered, that no defense of any prior party is good against the endorser, and that the endorser has no knowledge of any insolvency proceeding involving the payer.

Other issues concerning negotiable instruments are also covered in Article 3 of the UCC. In the case of a forgery, the negotiable instrument becomes inoperative. Antedated or past-dated instruments are not invalid, provided the dating was not done for fraudulent or illegal purposes. Negotiable instruments that have been materially altered without the permission of all parties involved are void. But a holder in due course who is not party to the material alteration can enforce payment according to the instrument's original terms. Also covered in Article 3 are interpretations of contradictions that may appear from time to time in negotiable instruments.

SELF-ASSESSMENT EXERCISE I

Explain the term negotiable instrument.

3.1.2 Requirements of Negotiability of Negotiable Instruments

For an instrument to qualify as negotiable, it must meet requirements such as being: in writing; signed by the maker or the drawer; an unconditional promise or order to pay; stated in a fixed amount of money; payable on demand or at a definite future date; and payable to order or to a bearer. In general terms, the negotiability of an instrument revolves around the following elements:

1. Signatures

For an instrument to be negotiable, it must be signed by the maker or drawer. A signature may be any symbol made by the maker or drawer with the inherent intention to serve as a signature.

2. Unconditional

This is based on promise or Order. Therefore, a negotiable instrument must contain an express order or promise to pay. A mere acknowledgment of a debt is not sufficient as evidence of an affirmative undertaking on the part of the debtor to repay the debt. The exception to this rule is a Certificate of Deposit.

Unconditional promise or order holds that a promise or order is unconditional (and, therefore, not negotiable) if it states:

(i) an express condition to payment,
(ii) that the promise or order is subject to or governed by another writing, or
(iii) that the rights or obligations with respect to the promise or order are stated in another writing.

3. A Fixed Amount

Another requirement of negotiability is that negotiable instruments must state a fixed amount of money for payment. Fixed amount for payment means an amount that can be determined in relation to the face value of the instrument. This requirement applies only to the principal amount of money.

The instrument can reference an outside source to determine the rate of interest in the case of negotiation for payment before due date. Payable in money means the medium of exchange authorized or adopted by the country of origin, which can easily be converted into foreign currency.

4. Time for Payment

There are obvious scenarios that are considered herein such as identified and discussed below.

i) Payment on Demand

An instrument is made payable on demand, “at sight,” or “upon presentation” if it is subject to payment immediately upon being presented to the payer or drawee. Nevertheless, if there is no time for payment specified, a negotiable instrument is presumed to be payable on demand.

ii) Payment at a Definite Time

An instrument is payable at a definite time if it states that it is payable (a) on a specified date, (b) within a definite period of time, or (c) on a date or at a time readily ascertainable at the time the promise or order is made. Such instruments are frequently referred to as time instruments.

iii) Acceleration Clause

A clause that permits a payee or other holder of a time instrument to demand payment of the entire amount or balance due, with interest, if a certain event occurs, such as default in the payment of an installment when due.

iv) Extension Clause:

A clause in a time instrument that permits the date of maturity to be extended.

v) Order Instrument

A negotiable instrument that is payable "to the order of" an identified person or "to" an
identifiable person "or order."

vi) Bearer Instrument

It is a negotiable instrument payable "to bearer" or to "cash," rather than to an identifiable payee. Bearer refers to the person possessing a bearer instrument. Any instrument made payable in a manner such as follows is a bearer instrument:

(a) "Payable to the order of bearer";
(b) "Payable to Adejo Hamid or bearer";
(c) "Payable to bearer";
(d) "Pay cash"; or
(e) "Pay to the order of cash."

SELF-ASSESSMENT EXERCISE 2

What are the requirements for negotiability of negotiable instruments?

3.1.3 Liability Associated with Negotiable Instruments

There are two kinds of liability associated with negotiable instruments:

1) Signature Liability

Those who sign negotiable instruments are potentially liable for payment of the amount stated on the instrument. Makers and acceptors (drawees) that promise to pay an instrument when it is presented for payment at a later time are primarily liable. Drawers and endorsers are secondarily liable only if the instrument is properly and timely presented, the instrument is dishonored, and timely notice of dishonor is given to the secondarily liable party.

2) Warranty Liability

Warranty liability extends to both signers and non-signers. It falls into two categories; transfer of liability, and presentment liability.

i) Transfer Of Liability

One who transfers an instrument for consideration makes the following warranties to all subsequent transferees and holders who take the instrument in good faith:

a) The transferor is entitled to enforce the instrument.
b) All signatures are authentic and authorized.
c) The instrument has not been altered.
d) The instrument is not subject to a defense or claim of any party that can be asserted against the transferor.
e) The transferor has no knowledge of any insolvency proceedings against the maker, the acceptor, or the drawer of the instrument.

ii) Presentment Liability

A person who presents an instrument for payment or acceptance makes the following presentment warranties to any other person who in good faith pays or accepts the instrument.

a. The person obtaining payment or acceptance is entitled to enforce the instrument or is authorized to obtain payment or acceptance on behalf of a person who is entitled to enforce the instrument (there are no missing or unauthorized endorsements).
b. The instrument has not been altered.
c. The person obtaining payment or acceptance has no knowledge that the signature of the drawer of the instrument is unauthorized.

The world's daily transactions are carried out through negotiable instruments. This implies that every entrepreneur or business entity must be familiar with the basic types of negotiable instruments, their proper transfer, the responsibilities of the parties to such instruments, and factors that may affect their value.

3.1.4 Types of Negotiable Instruments

There are four types of negotiable instruments:

1. Bank drafts

Bank draft is an instrument which falls under a classification of "promises to pay." Draft is an unconditional order to pay by which the party creating the draft (the *drawer*) orders another party (the *drawee*), typically a bank, to pay money to a third party (the *payee*).

Several other drafts include; **i) Time Draft**, a draft payable at a time certain; **ii) Sight Draft**, a draft payable on presentment; and **iii) Trade Acceptance**, a draft that is drawn by a seller of goods ordering the buyer to pay a specified sum of money to the seller, usually at a specified future time. The buyer *accepts* the draft by signing and returning it to the seller.

2. Cheques

The cheque is also an instrument which falls under a classification of "promises to pay." Cheque is a draft which involves ordering a drawee bank to pay the amount written on it (face value) and payable to the payee on demand. In other words, a Cheque is an instrument which compels the drawer (or the *maker*) to pay a fixed sum of money to another person (the *payee*) on demand or at a specified future time.

3. Promissory Notes

A promissory note is a written promise made by one person (the maker) to another (usually the payee) payable either on demand or at a definite time.

4. Certificates of Deposit

A certificate of deposit (CD) is a type of note issued when a party deposits money with a bank, with the bank promising to repay the money, with interest, on a certain date. In other words, a certificate of deposit is a note by which a bank or similar financial institution

acknowledges the receipt of money from a party and promises to repay the money, plus interest, to the party on a certain date.

SELF-ASSESSMENT EXERCISE 3

Mention and explain briefly various types of negotiable instrument.

3.2 Cheques

3.2.1 Meaning of Cheque

In simple terms, a cheque is a form of bill of exchange that is normally drawn on a specified bank carrying the name of the payee and payable on demand. As a form of bill of exchange, a cheque is monetary instrument in writing containing an unconditional order, signed by the drawer directing a named bank to pay a certain sum of money only, to the payee or to the order of the payee or to the bearer of the instrument.

A cheque is not invalid merely on the ground that it is ante-dated or post-dated, or that it bears a date of a public holiday. A cheque not dated at all is also valid. Any holder of the cheque, including the banker, may insert a date. Nevertheless, bankers generally return undated cheques. According to the decision in *Dalton vs Grifiths,* a banker is not bound to honour undated cheques. An ante-dated cheque is one which bears a date earlier than the date of issue. A banker cannot refuse payment of a cheque merely on the ground that it is ante-dated.

A post-dated cheque is one which bears a date later than the date of issue. A post-dated cheque is a negotiable instrument. An example may make the point clear. 'A' gives 'B' a post-dated cheque. Before the due date 'B', gives it to 'C' in payment of a debt. 'C' takes the cheque in good faith. 'A' stops payment of the cheque because of 'B's failure to fulfil his contract. Nevertheless, 'C' acquires a good title to the cheque and when the due date arrives, he can sue 'A' for the amount.

Based on above definitions, it follows that an instrument to be called a 'cheque' must fulfill the following conditions:

1) The instrument must be in writing. Legally speaking, the writing may be done by means of Printed characters, computer, typewriter, or by pen or pencil. But bankers generally do not honour cheques drawn in pencil, unless confirmed by the drawer. This is because it is easy to make unauthorized alterations when a cheque is drawn in pencil.

2) The instrument must contain an unconditional order.
For instance, if the banker is ordered to pay a certain amount, provided the payee fulfills certain conditions, it cannot be considered as a 'cheque' since the order is a conditional one. However, if such instructions are addressed to the payee and not to the banker, the order to pay may be regarded as an unconditional one.

3) The maker must sign the instrument. In order to be a valid 'cheque', the instrument must contain the signature of the drawer. In the case of an illiterate person, his/her thumb impression will be sufficient. Pencil signatures are discouraged by the banker, although it is legally permissible. So also, signatures impressed on the cheque by means of rubber stamps generally not permitted.

4) The order to pay must be addressed to a banker and that banker must be a specified one. In other words, the instrument should not only be drawn on a banker, but also on a 'specified' banker.

5) The order must be for a 'certain sum of money only'. The term 'money' implies legal tender currency. Thus, if the order is for something other than legal tender currency, the instrument will not be considered a 'cheque'. Further, the sum of money must be certain. Here, it may be pointed out that the amount should be considered as a 'certain amount' even when the cheque is drawn in a foreign currency. Also, the amount is certain even when it is payable with interest at a given rate up to the date of happening of a fixed future event.

6) The instrument must be payable to or to the order of a certain person or to the bearer. It follows that if a cheque is not payable to the bearer, the payee must be named or otherwise indicated with reasonable certainty. He may be designated as the holder of an office. Further, the payee need not be a human being. It can be a legal person, that is, a company or business entity.

7) Amount must be payable on demand.

SELF-ASSESSMENT EXERCISE 4

Mention the conditions that must be fulfilled by an instrument to be called a cheque.

3.2.2 Differences between a Cheque and a Bill of Exchange

1) A bill of exchange may be drawn on any person, and the person need not necessarily be a banker. On the other hand, a cheque is a bill of exchange drawn on a 'specified banker'.

2) A bill of exchange may be made payable on the expiry of a certain period after the date. But a cheque is not expressed to be payable otherwise than on demand.

3) Acceptance is necessary in the case of a bill of exchange. It is not so in the case of a cheque.

4) 'Days of Grace' are allowed in the case of time bills. But in the case of cheques, days of grace are not allowed.

5) Cheques may be crossed. A bill of exchange cannot be crossed.

6) The payment of a cheque should be suspended on the receipt of notice of death or insolvency of the drawer. This is not the case with a bill of exchange.

3.2.3 Crossing of Cheques

The Negotiable Instruments Act, 1881 recognises 'crossing' of cheques. A crossing is a direction to the paying banker that the cheque should be paid only to a banker and if the name of the banker is mentioned in the crossing, only to that banker. In other words, the holder of a crossed cheque is not entitled to cash the cheque across the counter. This ensures the safety of payment by means of cheques.

There are two kinds of crossing, viz., 'general crossing' and 'special crossing'.

1. General Crossing

Section 123 of the Negotiable Instruments Act defines a general crossing as follows:

Where a cheque bears across its face an addition of the words and company or any abbreviation thereof between two parallel transverse lines, or of two parallel transverse lines simply with or without the words 'not negotiable' that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally.

Two parallel, transverse lines are the essential part of a general crossing. The words 'and company', 'account payee', 'payee's account', 'account payee only', 'not negotiable', etc., do not, in the absence of two parallel transverse lines, constitute general crossing.

When a cheque is crossed generally, the paying banker should not make payment except through a banker. The addition of the words "account payee" or "payee's account" to the crossing increases the safety of the cheque. Such words, however, cannot strictly be considered additions to the crossing. The paying banker's position remains practically the same, and they are intended to warn the collecting banker that the amount should be collected only for the benefit of the account of the payee.

The words "not negotiable" also do not place any additional responsibility on the paying banker. The words merely act as a warning that the transferee of such a cheque shall not be capable of acquiring a better title to it than was possessed by his immediate transferor, and no duty is imposed on the paying banker to enquire into the title of the holder. The "not negotiable" crossing does not make the cheque non-transferable. Nevertheless, the transferee does not get a better title than that of the transferor, as was held in *Great Western Railway Company Vs London and County Banking Co.*

2. Special Crossing

Section 124 of the negotiable Instruments Act defines a 'special crossing' as follows:

Where a cheque bears across the face an addition of the name of a banker with or without the words 'not negotiable', that addition shall be deemed to be crossing and the cheque shall be deemed to be crossed specially to that banker

A special crossing warns the paying banker that the amount of the cheque should be handed over only to the bank whose name is mentioned in the crossing. It is not necessary that there should be two parallel transverse lines in the case of a special crossing. The name of a bank is sufficient to constitute a special crossing. A specially crossed cheque may be made more secure by the addition of such words as 'account payee', negotiable' etc., the significance of which is explained in the preceding section.

SELF-ASSESSMENT EXERCISE 4

Differentiate between general crossing and special crossing of cheques.

3.2.4 Persons Authorised to Cross or to Open Crossed Cheques

Section 125 of the Negotiable Instruments Act, which corresponds with Section 77 of the Bill of Exchange Act, lays down that:

i) A cheque may be crossed generally or specially by the drawer.
ii) Where a cheque is uncrossed, the holder may cross it generally or specially.
iii) Where a cheque is crossed generally or specially, the holder may add the words not negotiable.
iv) Where a cheque is crossed specially the banker to whom it is crossed may again cross it specially to another banker, his agent, for collection.
v) Where an uncrossed cheque or a cheque crossed generally is sent to the banker for collection, he may cross it specially to himself".

It should, however, be noted that in the last case, such crossing does not enable the collecting banker to avail himself of the statutory protection against being sued for conversion.

The drawer alone has the right to open a crossed cheque by writing the words "please pay cash" and adding his signature to it. It should be noted here that this method of opening a crossing does not have any legal authority behind it. It is dependent on the custom of bankers. As observed by Sheldon, if the drawer's opening and signature are forged, and the forger succeeded in cashing the cheque, the banker would undoubtedly be unable to debit his customer, and would also be liable to the true owner.

3.2.5 Cheque Endorsements

An 'endorsement' is the signature of the drawer or holder of a negotiable instrument for the purpose of negotiation. In terms of Section 15 of the Negotiable Instruments Act, when the maker or holder of a negotiable instrument signs the same otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or signs it for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to endorse the same, and is called the endorser. Thus an endorsement may be made either on the face or back of the instrument or on a slip of paper annexed thereto, although it is generally made on the back of the instrument. The slip of paper annexed to the instrument for the purpose of making the endorsement is known as "allonge".

1. Significance of Endorsements

When a cheque is endorsed and delivered, the endorsee or transferee gets a valid title to it. He, in turn, can negotiate the cheque to anyone he likes, provided his endorser does not restrict further endorsements.

The transferor, by his act of endorsing the cheque, warrants to his immediate transferee or to any subsequent holder, that when the cheque left his hands he had a good title to it, that it was a genuine one in every particular at the time of his endorsement, and that any endorsements on it previous to his own were genuine endorsements. Thus, if the cheque is dishonoured, the holder can sue any or all of the previous parties, and recover the amount of the cheque from any or all the previous parties.

When, however, a cheque is endorsed back to an earlier endorser, the intermediate parties are not liable to him; technically known as 'negotiation back'. For instance, 'A' endorses a cheque to 'B'; 'B' to 'C'; 'C' to 'D'; 'D' to `E' and `E' back to 'A'. The cheque is thus 'negotiated back' to 'A', and 'A' is now the holder of the cheque. If the cheque is dishonoured 'A' can sue `E', 'D', 'C' or 'B'. Nevertheless, he himself is liable to `E', 'D', 'C' and 'B' as the original endorser. Hence, if 'A' is allowed to sue `E', 'D', 'C' or 'B', they, in turn, can sue 'A'. In order to prevent this action, 'A' is not allowed to sue the intermediate parties. 'A' can further negotiate the cheque if he cancels the endorsements of the intermediate parties, namely 'E', 'D', 'C' and `E'. This is technically known as "taking up of a bill".

2. Kinds of Endorsements

There are different kinds of endorsements such as endorsements in blank, endorsements in full, restrictive endorsements, partial endorsements and conditional endorsements.

i) An Endorsement In Blank

It is also otherwise known as a `general endorsement', it specifies no endorsee. The endorser merely attaches his signature. The cheque then becomes payable to the bearer. When the endorsement specifies the person to whom, or to whose order, the cheque is payable, it becomes a `full endorsement', otherwise known as a 'special endorsement'. For instance, if a cheque is payable to 'A' or order, and he simply puts his signature on the back of the instrument, the endorsement is an `endorsement in blank' - the cheque becomes payable to the bearer.

ii) Endorsement In Blank

Suppose 'A' specifies the name of the endorsee as 'B' above his signature, then the endorsement is an 'endorsement in full'. Any holder of a cheque with an endorsement in blank may convert it into an endorsement in full. Under Section 49 of the Negotiable Instruments Act, a holder of a cheque endorsed in blank may convert it into an endorsement in full by writing a direction above the endorser's signature to pay the instrument to another person or to his order. Here, the transferor stands to gain by the endorsement in that he transfers the instrument without incurring the liabilities of an endorser.

For instance, a cheque is originally payable to 'A' or order. 'A' endorses the cheque in blank and delivers it to 'B'. The cheque is payable to the bearer. However, if 'B' adds the words "pay to C or order" above the signature of 'A', the endorsement becomes an endorsement in full. The cheque is then payable to 'C' or order. It is important to note here that 'B' is not liable on the instrument since this endorsement acts as an endorsement in full from 'A' to 'C'.

iii) Restrictive Endorsement

A 'restrictive endorsement' is one which prohibits further negotiation of the cheque, or which expresses that it is a mere authority to deal with the instrument as thereby directed and not a transfer of ownership thereof. For example, if the cheque is endorsed "Pay 'X'. only" or "Pay 'X' for the account of 'A" or "Pay 'X' or order for collection" or "the within must be credited to 'X' or "Pay 'X' for my use", it becomes a restrictive endorsement.

A restrictive endorsement gives the endorsee the right to receive payment of the cheque and to sue any party thereto which his endorser could have sued; but gives him no right to transfer his rights to *an* endorsee unless it expressly authorizes him to do so. Where a restrictive endorsement authorizes further transfer, all subsequent endorsees take the cheque with the same rights, subject to the same liabilities as the first endorsee under the restrictive endorsement.

iv) Partial Endorsement

A 'partial endorsement' is one which purports to transfer to the endorsee only a part of the amount payable. In terms of Section 56 of the Negotiable Instruments Act, a partial endorsement does not operate as a negotiation of the instrument.

v) Conditional Endorsement

A 'conditional endorsement' excludes the liability of the endorser. Thus, if an endorser wants to get rid of his liability in the event of the cheque being dishonoured, he can do so by writing the words *'sans recourse'(i.e.,* without recourse to me) after his endorsement. Here the endorser excludes his liability on the instrument Thus, if 'A' endorses the cheque with the addition of the words 'without recourse to me', subsequent endorsees cannot proceed against 'A' in case the instrument is dishonoured.

By the same token, in terms of Clause 2 of Section 22 of the Negotiable Instruments Act, where such an instrument is negotiated back to 'A', all intermediate endorsers are liable to him. For instance, 'A' endorses a cheque with the words 'without recourse to me' to 'B', 'B' endorses it to 'C', 'C' to '1D' and 'D' to 'E'. Here, 'A' is not liable on the instrument to 'B', 'C', 'D' or `E'. If, however, the cheque is negotiated back to 'A', 'B', 'C', 'D' and `E' are liable to him.

A conditional endorsement may make the liability of the endorser dependent on the occurrence of a contingent event, or may make the right of the endorser to receive payment in respect of the instrument dependent on the occurrence of such an event. Such conditions may either be 'conditions precedent' or 'conditions subsequent'. In the case of a condition Precedent the right to recover the amount does not pass on to the endorsee until the condition is fulfilled. For instance, where a cheque is endorsed with a condition 'pay 'A' on his marrying 'X', it is a condition precedent. 'A' gets title to the cheque only if he marries 'X'.

In the case of a condition subsequent, the right of the endorsee is defeated on the fulfillment of the condition. For instance, where a cheque is endorsed with a condition ‘pay 'A' or order unless before payment, the cheque is countermanded", it is a condition subsequent. The endorsee does not get a title if, before payment, the condition is fulfilled.

When an endorser extends his own liability by stipulating in the endorsement that he waives presentment or notice of dishonour, it is known as a 'facultative endorsement'. When an endorser does not want the endorsee or any other holder to *incur* any expense on his account on the instrument, the endorsement is *sans frais.* In this connection, an important difference between conditional and restrictive endorsement may be noted. In the former case, the negotiability of the instrument is not affected. In the latter case, the negotiability of the instrument is restricted.

3.2.6 Marking of Cheques

There is a usage among bankers to mark a cheque 'good'. This marking indicates that at the time of marking, the paying banker had sufficient funds of the drawer to meet the cheque. Here, the question arises whether the paying banker, by marking a cheque 'good', undertakes to honour it when presented. It depends on whether the cheque is marked 'good' at the request of the drawer, or of the holder, or of another banker.

When the drawer requests his bank to mark the cheque good, he may do so. The bank is then entitled to retain money to meet the cheque, and he is justified in dishonouring other cheques where the balance is insufficient. In other words, the bank is justified in regarding the cheque as constructively paid. Once a marked cheque has left the drawer's possession, he is not entitled to countermand its payment. Such a cheque must be paid when presented notwithstanding the death, bankruptcy or insanity of the drawer, or by the service of a garnishee order.

As observed by Sheldon, the practice of marking a cheque is undesirable and should be discouraged. The better course would be to debit the customer at once with any cheque marked 'good' at his request, and credit the amount to a suspense account, which should be debited when the cheque is presented for payment. Or, the banker may issue a draft on demand against debit of the cheque to the customer.

Marking a cheque at the request of the payee or holder does not place any liability on the paying banker. Such a marking only means that at the time of marking, the banker had sufficient funds to meet the cheque. When a banker marks a cheque at the fellow bank for clearance purposes, the paying banker is undertaking an obligation to honour it. In *Goodwin vs Roberts,* was held that a custom had grown among bankers of marking cheques as 'good' for purposes of clearing by which they bound to one another. Thus, marking a cheque for clearance purposes entitles the paying banker to earmark the necessary funds to meet the cheque.

According to Sir John Paget, such marking constitutes a constructive payment or appropriation to a specific person, though not directly indicated by the customer. Here again, the customer has no right to countermand payment of the cheque. Also, the marking is not affected by the death, bankruptcy, or lunacy of the drawer, or by the service of a garnishee order.

3.3 Holder and Holder In Due Course

3.3.1 Holder of a Negotiable Instrument

In terms of Section 8 of the Negotiable Instruments Act, the holder of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto.

Thus, the holder of a negotiable instrument is a person who is legally entitled to recover the amount from the parties of the instrument and who is in possession of the instrument. Here the Indian Law makes a slight departure from the English Law. Under the Bills of Exchange Act, a holder means the payee or endorsee of a bill or note, who is in possession of it, or the bearer thereof In terms of this definition, the holder need not necessarily be a lawful holder. For instance, the finder of a cheque duly endorsed as payable to bearer is a holder. But according to the Negotiable Instruments Act, 'holder in due course' as follows:

3.3.2 Holder in Due Course of a Negotiable Instrument

Section 9 of the Negotiable Instruments Act defines a ‘holder in due course’ as follows:

Holder in due course means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque if payable to bearer; or the payee or endorsee thereof if payable to order, before the amount mentioned in it became payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

Thus, a holder in due course is a person who:

1. Is in possession of the instrument as defined in Section 8;
2. Obtains possession of the instrument before maturity;
3. Obtains possession of the instrument for valuable consideration (valuable consideration in the case of a negotiable instrument is always presumed until proved to the contrary);
4. Is a holder without sufficient cause to believe that any defect existed in the title of the person from whom he received his title.

Here again, the Negotiable Instruments Act differs slightly from the Bills of Exchange Act. According to Section 29 of the Bills of Exchange Act:

A holder in due course is a holder who has taken a bill complete and regular on the face of it, under the following conditions; namely, (a) that he became the holder of it before it was overdue and without notice that it had been previously dishonoured if such was the fact, (b) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.

From the above definition, it can be see that a person who takes an instrument in good faith is a holder in due course, irrespective of whether he negligently or not. In other words, the fact that a person has not exercised great caution or has not been negligent is in sufficient to dispute the title of the hold of a negotiable instrument, provided he has acted in good faith. Thus, according to the Negotiable Instruments Act, a person is expected to take an instrument with reasonable care and without negligence.

A holder in due course obtains absolute title, even if he takes the instrument from a thief. All the previous parties to the instrument are liable to him. An exception to this general rule may be found when the instrument bears a forged signature of the true owner. The transferee of such an instrument does not get a valid title except in the case of an estoppel.

3.4 Liability of the Drawer for Dishonour of Cheques

According to Negotiable Instruments Act, if a cheque is returned unpaid by a bank due to insufficiency of funds in the account of the drawer, or because the amount of the cheque exceeds the arrangement between the drawer person and the banker, then proceedings can be initiated against negligent the drawer of the dishonoured cheque. It involves a penalty of imprisonment. In order to make the drawer liable as above, proper procedures should be followed.

Section 138 draws a presumption that one commits the offence if he issues the cheque dishonestly. It, therefore, appears that where the drawer of a cheque gives notice to the holder before presentation of the cheque to the bank for payment and gives 'stop payment' instruction to the bank and the cheque is dishonoured with the remarks 'refer to drawer' or 'instruction to stop payment' or 'not sufficient funds', then the dishonest intentions of the drawer are established and Section 138 would be applicable.

The above analysis also highlights the risk involved in accepting post-dated cheques from debtors/ borrowers in discharge of their liabilities. It is, however, pointed out in some quarters that an appropriate undertaking by a debtor/borrower to the effect that he/she will not give any 'stop payment' instruction to the bank, that he/she will not close the bank account without prior written permission of the lender that he/she will not issue any notice to the lender requesting postponement of the presentation of the cheque for payment, giving an unqualified right to the holder in due course of the cheque to take legal action under Section 138 of the Negotiable Instruments Act in the event of the dishonour of the cheque, will be proper safeguard while accepting postdated cheques.

Such an undertaking will, in all probability, act as an effective check against the debtor/borrower in *giving* any notice for the Postponement of the presentation of the cheque for payment. This is because the debtor/ borrower cannot accept the benefit of an instrument and at the same time reject any conditions attached to it. This is all the more important since there is a likelihood for misinterpretation of the above judgment to suit the requirements of unscrupulous debtors/borrowers who endeavour to delay their liabilities.

4.0 CONCLUSION

From our discussion in this unit, we have stated that a negotiable instrument refers to a written document guaranteeing the payment of a specific amount of money, either on demand, or at a set time with the payer named on the negotiable instrument. Therefore, a cheque is one of such instruments that is amenable for baking transactions. There are mainly two types of cheques such as open cheques and crossed cheques with several variations. Customers of banks and banks themselves are bound by some regulations regarding the use and acceptance of cheques. Therefore, bankers in particular are to be diligent when dealing in customers' cheques in the normal course of banking business.

5.0 SUMMARY

In this study unit, we have discussed negotiable instruments and cheques while the analyses borders on: nature of negotiable instruments; meaning of negotiable instrument; requirements of negotiability of negotiable instruments; meaning of cheque; differences between a cheque and a bill of exchange; crossing of cheques; persons authorised to cross or to open crossed cheques; cheque endorsements; marking of cheques; holder and holder in due course; holder of a negotiable instrument; holder in due course of a negotiable instrument; and liability of the drawer for dishonour of cheques.

In the next study unit, we shall discuss negotiable instruments: cheques, promissory notes and bills of exchange.

6.0 TUTOR-MARKED ASSIGNEMENT

1. What is a negotiable instrument?
2. Give reasons why cheques are regarded as negotiable instrument.

7.0 REFERENCES/FURTHER READING

Dlabay, Les R.; Burrow, James L. & Brad, Brad (2009). *Intro to Business*. Mason, Ohio: South-Western Cengage Learning. p. 482. ISBN 978-0-538-44561-0.

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MODULE 2

UNIT 1 PROMISSORY NOTES AND BILLS OF EXCHANGE

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we discussed some forms of negotiable instruments and in the process, we did analyze the nature of negotiable instruments and cheques. There are other prominent types of negotiable instruments such as bills of exchange and promissory notes. In the course of the analysis in this unit, we shall espouse on instruments such as promissory notes and bills of exchange.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of promissory notes
- explain the nature of bills of exchange.

3.0 MAIN CONTENT

3.1 Promissory Notes

3.1.1 Definition of a Promissory Note

Section 4 of the Negotiable Instruments Act defines a 'promissory note' thus:

A promissory note is an instrument in writing (not being a Banknote or currency note) containing an unconditional undertaking, signed by the maker; to pay a certain sum of money only to or to the order of a certain person, or to the order of the instrument.

Thus, just like the case of a bill of exchange, a promissory note must be in writing and must be unconditional. Further, a promissory note must be signed by the maker. It must be for a certain amount of money only. It must be payable to or to the order of a certain person.

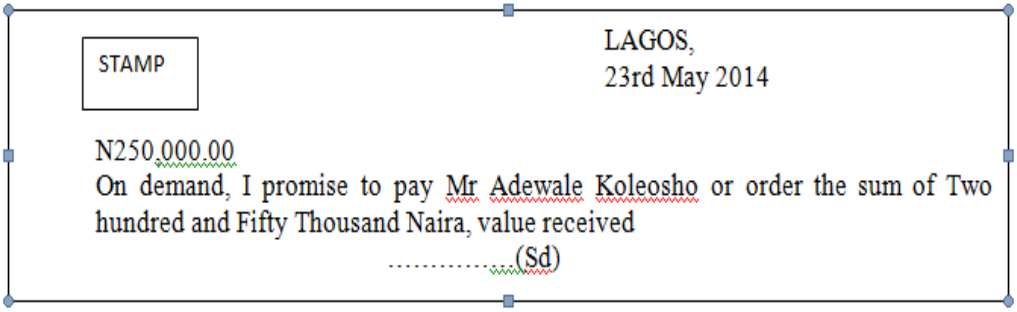
Section 5 of the Negotiable Instruments Act further espouses further on the instrument thus:

A promise to pay is not conditional within the meaning of this Section and Section 4, by reason of the time for payment of the amount or any installment thereof being expressed to be on the lapse of a certain period after the occurrence of a specified event which, according to the expectation of mankind is certain to happen, although the time of its happening may be uncertain.

Furthermore, the sum payable may be certain within the meaning of this Section and Section 4, although it includes future interest or is payable at an indicated rate of exchange, or is according to the course of exchange, and although the instrument provides that on default of payment of an installment the balance unpaid shall become due.

3.1.2 Kinds of Promissory Notes

1. Promissory Note Payable on Demand

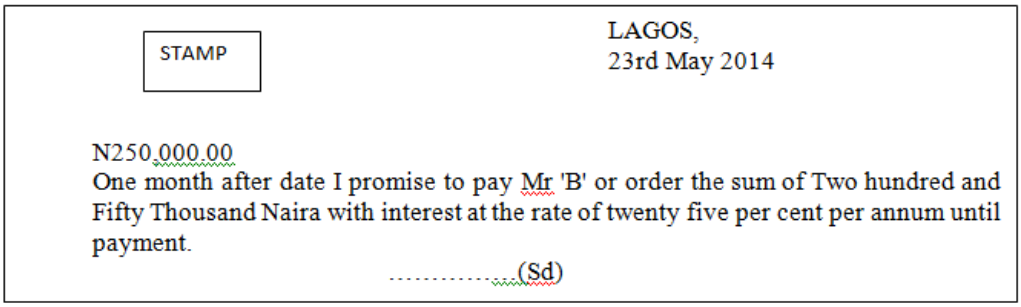

STAMP

LAGOS,
23rd May 2014

N250,000.00
On demand, I promise to pay Mr Adewale Koleosho or order the sum of Two hundred and Fifty Thousand Naira, value received

.....(Sd)

2. Promissory Note Payable after Date with Interest


STAMP

LAGOS,
23rd May 2014

N250,000.00
One month after date I promise to pay Mr 'B' or order the sum of Two hundred and Fifty Thousand Naira with interest at the rate of twenty five per cent per annum until payment.

.....(Sd)

SELF-ASSESSMENT EXERCISE 1

Explain the term Promissory Note and identify its peculiarities.

3.1.3 Legal Considerations

1. The words "whenever you demand" do not make the undertaking a conditional one

Such words do not make the obligation of the executant of the instrument conditional upon the actual demand being made by the person in whose favour the instrument is executed. The obligation arises as soon as the instrument is executed and those words are inserted merely in recognition of this obligation with a view to emphasizing that the amount should be payable immediately or forthwith. The implication these words is the same as "I promise to pay you on demand" and if the latter words do not have the effect of restricting negotiability, the former cannot have that effect.

Section 4 of Negotiable Instruments Act does not say that the name of the payee must be specified in the words of the promise nor does it say that the payee must be specified in any particular part of the instrument.

Nevertheless, the name of the payee might be set out on any part of the instrument, and as long as it appears clearly on the instrument taken as a whole that the instrument specified the payee with certainty, and the other ingredients of the definition were satisfied, it must be held to be a promissory note.

Section 4 of Negotiable Instruments Act provides that:

A document which is only a receipt enumerating the terms on which the amount is to be refunded must be distinguished from a document which is a promissory note. At the same time, an acknowledgment of receipt of the amount will not exclude the document from the category of a promissory note.

According to Section 4 of the Negotiable Instruments Act, the essential ingredients of a promissory note are:

(i) that the promise to pay must be unconditional;
(ii) that the note must be in writing and signed by the maker;
(iii) that the promise to pay must be for a certain sum of money; and
(iv) that the promise to pay must be to or to the order of a certain person or to the bearer of the instrument.

Furthermore, the above Section also shows that an acknowledgment of receipt of amount which is specified on the Promissory Note does not take away the document from the category of a promissory note. It is instructive to note that where a promissory note is executed by the managing partner of a firm, the other partners are also liable thereunder as makers.

For instance, if a promissory note is executed on behalf of a firm by its managing partner in renewal of prior promise on the strength of the fact that the promisee endorses the same, for consideration, in favour of the endorsee. If the endorsee files a suit against the endorser, the managing partner as well as all the other partners of the firm are liable for any breach. In view of Sections 5,18,19 and 22 of the Partnership Act, every partner was liable jointly with all other partners, and also severally, for all acts of the firm done while a partner. Hence since the document is executed by the managing partner, and since the monies drawn were utilized for the purpose of the firm, every partner is liable.

According to Section 16(2) of the Negotiable Instruments Act, the endorsee would stand on the same footing as the payee, and under Section 50 of the Act, the endorsement of a negotiable instrument followed by delivery would transfer the property therein to the endorsee with the right to further negotiation. Nevertheless, the endorsement may

by express words, restrict or exclude such right or may merely constitute the endorsee an agent to endorse the instrument, to receive its contents for the endorser or for some other specified person. Once there is no such restriction, the endorsee is entitled to protection from the partners of the firm for the amount due from those liable under the promissory note as makers.

2. A person who is not a holder of a promissory note is not entitled to sue for the amount due thereon

According to Section 78 of the Negotiable Instruments Act, payment of the amount due on a promissory note, in order to discharge the maker or acceptor, must be made to the holder of the instrument. The Act defines a "holder" to mean a person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto.

3. The liability on a promissory note is not affected by the body of the promissory note and the signature of the executant being in different ink

This implies that it is immaterial if the body of the promissory note and the signature of the executant are in different ink.

4. The assignor of a promissory note has a duty to indemnify the maker who is put to loss on account of the fraudulent act of the former

In the case of whether the assignor has a duty to indemnify the maker of a promissory note, if an allegation has been in which rendered the claim based on the same unenforceable. The status is that if the maker of a promissory note is made liable, he cannot proceed against the endorser as if the latter was a surety as the liability under the note is always and ultimately that of the maker.

And where the endorser negotiates a promissory note for the full value without giving credit to any payment that he might have received from the maker which is endorsed on the note, the case is one where the payee or the endorser fraudulently negotiates the note for the full value.

Therefore, the holder in due course in such an event cannot be prevented from collecting the money due on the promissory note according to its tenor and that, If the maker is put to loss on account of the fraudulent act of the payee or endorser his remedy would be only in the nature of damages and not amounting to an equitable claim of indemnity The maker who is in the position of principal debtor not having any right of

indemnity against the original payee or endorser would not have any right to proceed against the latter.

5. Negligence of the maker of a promissory note and the loss suffered by the endorsee

The above implies that where the maker of a promissory note fails to get partial discharge of the principal amount endorsed on the promissory note, and where and endorsee has no knowledge about the partial discharge, the maker will become liable to pay the endorsee the entire amount under the same. Although the maker may take appropriate steps for refund of the said amount from the original payee, he will have to suffer for the consequential losses against the endorsee.

6. Any alteration of a promissory note by the promisee inserting the rate of interest would amount to material alteration vitiating the instrument

Even though the law provides that Where a promissory note does not express the rate of interest payable thereon, six per cent interest shall be payable under Section 80 of the Negotiable Instruments Act, any alteration on the instrument would amount to material alteration, vitiating the instrument.

Section 20 of the Negotiable Instruments Act allows for filling up the endorse as regards the rate of interest. According to Section 20 of the Act, where one person signs and delivers to another, a paper stamped in accordance with the law relating to negotiable instruments either wholly blank or having written thereon an incomplete instrument, he thereby gives *prima facie* authority to the holder thereof to make or complete, as the case may be, not exceeding the amount covered by the stamp.

Nevertheless, Section 80 of the Act provides that where no rate of interest is mentioned, six per cent would be deemed to be the rate of interest payable, and therefore, a endorsee, which did not mention the rate of interest payable thereon, could not be said to be an incomplete instrument and consequently, a promisee had no authority to fill up the instrument with regard to the rate of interest. If he did so, it would amount to material alteration.

7. Negotiable instruments must come into existence only for the purpose of recording an agreement to pay money and nothing more, though, of course, they may state the consideration

A document is not a promissory note if the last sentence of the document promised the performance of an act in addition to the payment of

money. Negotiable instruments must come into existence only for the purpose of recording an agreement to pay money and nothing more, though, of course, they may state the consideration.

More often than not bankers often grant credit facilities on the basis of documents which contain a promise to pay money on stated dates. Some of these documents are lengthy, and the banker has to ensure that they do not contain any provision which may take them out of the category of promissory notes, as otherwise the banker may find that he will be unable to enforce rights against the concerned parties.

SELF-ASSESSMENT EXERCISE 2

Enumerate some legal considerations in relation to the use of Promissory Note.

3.2 Bills Of Exchange

3.2.1 Definition of Bills of Exchange

A bill of exchange or "draft" is a written order by the drawer to the drawee to pay money to the payee. A common type of bill of exchange is the cheque, which we have discussed in the preceding study unit, defined as a bill of exchange drawn on a banker and payable on demand. Bills of exchange are used primarily in international trade, and are written orders by one person to his bank to pay the bearer a specific sum on a specific date. Prior to the advent of paper currency, bills of exchange were a common means of exchange. They are not used as often in the modern business transactions.

According to the Bill of Exchange of 1933, a bill of exchange is essentially an order made by one person to another to pay money to a third person. A bill of exchange requires in its inception three parties—the drawer, the drawee, and the payee. The person who draws the bill is called the drawer. He gives the order to pay money to the third party. The party upon whom the bill is drawn is called the drawee. He is the person to whom the bill is addressed and who is ordered to pay. He becomes an acceptor when he indicates his willingness to pay the bill. The party in whose favour the bill is drawn or is payable is called the payee.

The parties to a bill of exchange need not all be distinct persons. Thus, the drawer may draw on himself payable to his own order. A bill of exchange may be endorsed by the payee in favour of a third party, who may in turn endorse it to a fourth, and so on indefinitely. The "holder in due course" may claim the amount of the bill against the drawee and all

previous endorsers, regardless of any counterclaims that may have disabled the previous payee or endorser from doing so. This is what is meant by saying that a bill is negotiable. In some cases a bill is marked "not negotiable" such as in crossing of cheques. Therefore, it can still be transferred to a third party, but the third party can have no better right than the transferor.

The Bills of Exchange Act defines bill of exchange and some other negotiable instruments as follows:

1. The Act defines a **bill of exchange** as: “an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to bearer.”
2. The Act defines a **cheque** as: “a bill of exchange drawn on a banker payable on demand.”
3. The Act defines a **promissory note** as: “an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer.”

SELF-ASSESSMENT EXERCISE 3

Explain the term bill of exchange.

3.2.1 Negotiation and Endorsement of Bill of Exchange

Persons other than the original obligor and obligee can become parties to a negotiable instrument. The most common manner in which this is done is by placing one's signature on the instrument. If the person who signs does so with the intention of obtaining payment of the instrument or acquiring or transferring rights to the instrument, the signature is called an endorsement.

There are five types of endorsements, which are mentioned and explained as follows:

i) Special Endorsement

An endorsement which purports to transfer the instrument to a specified person is a *special endorsement* – for example, "Pay to the order of Nnamani."

ii) Endorsement in Blank

An endorsement by the payee or holder which does not contain any additional notation (thus purporting to make the instrument payable to bearer) is an *endorsement in blank* or blank endorsement

iii) Restrictive Endorsement

An endorsement which purports to require that the funds be applied in a certain manner (for example, "for deposit only", "for collection") is a *restrictive endorsement*; and,

iv) Qualified Endorsement

An endorsement purporting to disclaim retroactive liability is called a *qualified endorsement* (through the inscription of the words "without recourse" as part of the endorsement on the instrument or in allonge to the instrument).

v) An endorsement purporting to add terms and conditions is called a *conditional endorsement*, for example, "Pay to the order of Ademulegun, if he clears my farmland on "May 30th , 2014".

If a note or draft is negotiated to a person who acquires the instrument in good faith; for value; and without notice of any defences to payment, the transferee is a holder in due course and can enforce the instrument without being subject to defences which the maker of the instrument would be able to assert against the original payee, except for certain real defences.

Such real defences include the following:

(1) forgery of the instrument;
(2) fraud as to the nature of the instrument being signed;
(3) alteration of the instrument;
(4) incapacity of the signer to contract;
(5) infancy of the signer;
(6) duress;
(7) discharge in bankruptcy; and
(8) the running of a statute of limitations as to the validity of the instrument.

The holder-in-due-course rule is a rebuttable presumption that makes the free transfer of negotiable instruments feasible in the modern economy. A person or entity purchasing an instrument in the ordinary course of business can reasonably expect that it will be paid when presented to,

and not subject to dishonor by, the maker, without involving itself in a dispute between the maker and the person to whom the instrument was first issued. This can be contrasted to the lesser rights and obligations accruing to mere holders.

SELF-ASSESSMENT EXERCISE 4

Enumerate and explain the various types of endorsement in respect of Bill of Exchange.

4.0 CONCLUSION

From our discussion in this unit, you have appreciated the fact that promissory note and bill of exchange share the same nature with all other negotiable instruments. Promissory Note just like the Bill of Exchange involves a written order by one person to his bank to pay the bearer a specific sum on a specific date. They are both contractual obligations and therefore, re governed by some legal rules and regulations, which must be taken into consideration whenever bankers are dealing with them.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed other negotiable instruments such as Promissory Note and Bill of Exchange in terms of: definition of a promissory note; kinds of promissory notes; legal considerations; bills of exchange; definition of bills of exchange; and negotiation and endorsement of bill of exchange. In the next study unit, we shall discuss duties of paying bankers and collecting bankers.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Define Bill of Exchange and Promissory Note.
2. Differentiate between Promissory Note and Bill of Exchange.

7.0 REFERENCES AND MATERIALS FOR FURTHER READING

Dlabay, Les R.; Burrow, James L. & Brad, Brad (2009). *Intro to Business*. Mason, Ohio: South-Western Cengage Learning. p. 482. ISBN 978-0-538-44561-0.

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UNIT 2: DUTIES OF PAYING BANKERS AND COLLECTING BANKERS

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we discussed negotiable instruments such as promissory notes and bills of Exchange. In this study unit, we shall discuss the responsibilities of both paying and collecting bankers in negotiable instruments like cheques, bank drafts, promissory notes and bills of Exchange in the normal course of the banking operations.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of negotiable instruments
- explain the nature of cheque as a form of negotiable instruments.

3.0 MAIN CONTENT

3.1 Negotiable Instruments

In this subsection of the unit, we have to revise the realm of negotiable instruments. On the basis of section 13 of the negotiable instrument Act. 1881, "A negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer," which also involves a Banker's draft. Such negotiable instruments as discussed in earlier study unit include the following:

1. Promissory Note

A promissory note is an instrument in writing containing an unconditional under taking signed by the maker to pay on demand or at a fixed or determinable future time a certain sum of money only to, or to the order of a certain person, or to the bearer of the instrument.

2. Bill of Exchange

A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay on demand or at a fixed or determinable future time a certain sum of money only to or the order of a certain person or to the bearer of the instrument.

3. Cheque

A cheque is an unconditional order of the drawer in writing bearing a date, to the Banker maintaining his account to pay on demand, to a named person, his order or bearer, a certain specified sum of money, expressed in both figures and words.

4. Bank Draft

A bank draft is an unconditional order to pay by which the party creating the draft, that is the *drawer*, orders another party, that is the *drawee*, typically a bank, to pay money to a third party, that is the *payee*.

5. Quasi Negotiable instruments: There are some instruments which are Quasi Negotiable instruments in nature. These are instruments which are in practice, treated negotiable for certain events only and are so regarded by usage and custom. Some of these are documents of title of goods and property while others are documents of value. Such as, bill of lading, railway receipts,

stock and share certificates, debentures, dividend warrants, interest coupons and treasury bills.

SELF-ASSESSMENT EXERCISE 1

Enumerate and explain various types of negotiable instruments.

3.2 Paying Banker

The paying banker is one who undertakes to pay various types of instruments representing money on behalf of his customer or his own behalf from the drawers of such instruments, some of which are negotiable instruments as provided for in the negotiable instruments Act 1881 while some other ones are quasi negotiable instruments.

3.2.1 Paying Bankers' Duties and Responsibilities

A banker on whom the cheque is drawn should pay the cheque, when it is presented for payment. It is his obligation to make payment for his customers on the strength of cheques presented to the bank to the extent of the fund available and the existence of no legal bar for payment. The paying banker should use reasonable care and diligence in paying a cheque so as to abstain from any action likely to damage his customers' credit reputation.

At the time of making payment for the customers, the bankers should observe the following very carefully:

i. Verification of signature of the drawer.
ii. Verification of the genuineness of the instrument.
iii. Payment not stopped by the account holder.
iv. Holders title on the cheque is valid.
v. Account is not dormant one.
vi. Account holder is not bankrupt, deceased and insane.
vii. Account is not under subject of liquidation process.
viii. No 'Guernsey Order' is issued by count.
ix. Properly endorsed.
x. Cheque is not drawn beyond limit fixed by the drawer is respect of amount.
xi. Instrument being presented is crossed.
xii. Instrument is not state or postdated.
xiii. No material alteration is made.
xiv. Sufficient balance in the account.

SELF-ASSESSMENT EXERCISE 2

Enumerate the considerations for making payments by the banks.

3.2.2 Important Considerations for Payment of Cheques

There are important considerations to be observed while honouring customer's cheques up to the amount of credit balance in his account, or up to the limit of any agreed overdraft. Such considerations include the following:

1. The cheque must be in the proper form

It must satisfy the conditions specified in the Negotiable Instruments Act such as:

i) Section 6: A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand.

ii) Section 5: A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of, a certain person or to the bearer of the instrument.

A promise or order to pay is not conditional within the meaning of this Section and Section 4, by reason of the time for payment of the amount, or any installment thereof, being expressed to be payable on the lapse of a certain period or after the occurrence of a specified event.

The sum payable may be certain within the meaning of this Section and Section 4, although it includes future interest or is payable at an indicated rate of exchange, and the instrument provides that, on default of payment of an installment, the balance unpaid shall become due.

2. Drawer's signature must correspond with the specimen signature

The signature of the drawer on the cheque must correspond with the specimen signature obtained by the banker at the time of opening the account. The question of negligence on the part of the customer, such as leaving the cheque book carelessly, would afford no defence to the bank where the signature – or where two persons are authorized to operate on the account, either the signatures or one of the signatures to the cheque is not genuine.

3. The cheque must not be either stale or postdated

A stale cheque is one which has been in circulation over an unreasonably long period. The custom of bankers in this respect varies. Generally a cheque is considered as stale when it has been in circulation for more than six months and bankers return such cheques for the drawer's confirmation. A postdated cheque is one which bears a date later than the one on which the cheque is actually drawn.

A banker should not pay a postdated cheque before it is due for payment. As posited by Sir John Paget, a banker who pays a postdated cheque before the ostensible date stands a very poor chance of being able to debit his customer with it in any conceivable circumstances if the customer chooses to object to be debited. It is to be noted that a banker honouring a postdated cheque will lose his statutory protection. Relatedly, Sheldon has pointed out the following dangers in honouring a postdated cheque:

(a) If a person finds a postdated cheque and is able to get it cashed by the drawee banker before the date written on the cheque, the banker will be liable to the drawer for the amount.

(b) If a banker pays a postdated cheque, and dishonours other cheques, which would otherwise have been paid, he will be liable to his customer for damage to his credit.

(c) If a banker holds a postdated cheque pending the arrival of the due date, the customer may fail in the meantime. And the banker cannot debit his customer's account with a postdated cheque on arrival of its due date if the customer stops payment of it before such date.

4. The amount should be expressed in words, or in words and figures which should agree

Bankers generally pay cheques bearing the amount in words only, but return cheques bearing the amount in figures only marked 'amount required in words'. When the amount in words differs from that in figures, a banker is justified in returning it marked 'words and figures differ'.

However, Section 18 of the Negotiable Instruments Act provides that where there is a difference between the amount in words and the amount in figures, the amount in words is the amount payable.

5. The banker should be careful when mutilated cheques are presented for payment

A cheque is mutilated when it has been cut or torn, or when a part of it is missing. Mutilation may be accidental or intentional. When it is accidental, the banker should get the drawer's confirmation before honouring it. In the latter case, the banker should refuse payment. Otherwise, the drawer can refuse to be debited with such a cheque. Hence the banker should return such a cheque marked mutilated cheque or mutilation requires confirmation.

6. Material alterations must be confirmed by the drawer

An alteration which in any way alters materially or substantially the operation of the instrument and the liabilities of the parties thereto, irrespective of whether or not the change is prejudicial to the payee, is material. This includes alteration of the date, the crossing, the place of payment, the amount and the name of the payee.

In terms of Section 87 of the Negotiable Instruments Act:

Any material alteration to a negotiable instrument renders the same void as against anyone who is a party thereto at the time of making such alteration, and does not consent thereto, unless it was made in order to curly out the common intention of the original parties; and any such alteration, if made by an endorsee, discharges his endorser from all liability to him in respect of the consideration thereof.

Hence, this implies that material alterations make a cheque void. Hence a banker honouring a cheque with material alterations is not allowed to debit his customer's account or else, he should make sure that material alterations are confirmed by the drawer. In case the cheque is signed by more than one person, material alterations should be confirmed by the signature of all the persons.

When either party to a joint account has authority to sign cheques alone, the signature of one is sufficient; and that need not necessarily be the one who originally signed the cheque. In case of corporate bodies, alterations should be confirmed not only by the Secretary but by all the signatories, unless the Secretary alone has the power to issue and sign cheques for the company.

The drawer may convert an order cheque into a bearer cheque by substituting the word 'bearer' for order. However, only the drawer has such a power and any such alteration should be confirmed by him. In the case of a bearer cheque, any holder may alter it to an order cheque.

Here, the drawer's confirmation is not necessary.

Alteration of the name of the branch at which the cheque is payable, the opening of crossing, deletion of the words 'not negotiable', alteration of the amount payable, the date of payment, etc. should be confirmed the drawer's signature. To be on the safe side, it is advisable for the paying banker to make sure that all alterations are confirmed by the full signature of the drawer.

A paying banker honouring cheque which has been materially altered, without the drawer's confirmation, cannot debit the drawer's amount. However, this general rule is subject to one important qualification. A banker is justified in honouring a cheque that bears a non-apparent alteration.

7. The cheque must be properly endorsed

In the case of a bearer cheque, endorsement is not legally necessary. In the case of an order cheque, endorsement is necessary. An order cheque may be made payable to the bearer by an endorsement in blank. Further, a cheque originally expressed to be payable to bearer always remains a bearer cheque. This is expressly laid down in the Negotiable Instruments Act. Under Section 85 of the *Act:*

Where a cheque is originally expressed to be payable to bearer the drawee is discharged by payment in due course to the bearer thereof notwithstanding any endorsement whether in full or in blank that any such endorsement purports to restrict or exclude further negotiation.

Before honouring a cheque, the paying banker should see that the endorsements on the cheque are regular. Certain general rules regarding endorsements have been discussed in a preceding study unit. Let us recap the rules as follows:

i) The endorsement must literally follow the spelling of the payee's or endorsee's name as used by the drawer or endorser, irrespective of whether or not it is wrongly spelt.

ii) According to Sir John Paget, the paying banker is justified in returning the cheque marked 'endorsement illegible' or 'endorsement requires confirmation that the oriental characters represent the equivalent of the name of the person whose endorsement is necessary'. The certified translation of a notary public may be accepted.

iii) A banker is justified in returning cheques bearing an endorsement that includes a courtesy title. In other words, an endorsement should be in the form of ordinary signature of the payee or endorsee. Also, complimentary prefixes, suffixes, and other courtesy titles do not form art of endorsements. Such endorsements are considered regular in certain countries.

iv) In the case of fictitious payees, no endorsement is required. Such cheques are generally considered to be bearer cheques. For instance, when the payee is named 'Father Christmas', no endorsement is required.

8. The paying banker must not pay a cheque in a manner inconsistent with the directions contained in the crossing

Where a cheque is crossed generally, the banker on whom it is drawn shall pot pay it otherwise than to a banker. Where the cheque is crossed specially, payment shall be made only to the banker to whom it is crossed, or his agent for collection. The addition of the words 'not negotiable', 'account payee' etc. does not materially affect the position of the paying banker.

SEL-ASSESSMENT EXERCISE 3

Enumerate the important considerations for payment of cheques.

3.2.3 Circumstances under Which a Banker Is Justified in Refusing Payment of a Cheque Drawn On Him

A banker's obligation to honour his customer's cheques is terminated on the occurrence of any one of the following events:

At the instance of a notice from the customer to stop payment (countermanding payment):

a) The banker should obtain instructions in writing concerning the drawer stopping the payment of a cheque. Such instructions should contain the number, the date, the amount and the name of the payee of the cheque, and should be signed by the drawer. The payment of a cheque can be countermanded by one of the several partners, trustees or executors. So also, when cheques are to be signed by any of the two directors of a joint stock company, its payment can be stopped by any director.

b) When a banker honours a cheque, the payment of which has been stopped by the drawer through written instructions, the banker

will have to bear any loss arising therefrom.

c) A banker should not stop payment of a cheque in relying on instructions by telephone or telegram. At best, he may return the cheque marked 'payment countermanded by telegram/telephone; payment postponed *pending* confirmation, present *again'*. Meanwhile, the banker should try to obtain the drawer's written confirmation.

d) The paying banker owes no duty to a holder of a cheque concerning stop payment instructions from him. As such he should not rely on the instructions from a holder that the cheque has been lost should request the holder to obtain written instructions from the drawer. If the cheque presented in the meanwhile, he may return cheque as in the case of countermanding payment by telegram. However, he should be careful to ensure that he does not damage customer's credit reputation.

e) If the holder of an order cheque, having lost it, informs the banker that he has not endorsed it, payment should be refused because the presentee must be claiming through forged endorsement. If the banker pays such a cheque, he may be held liable for not *acting* in good faith and for negligence.

f) Payment of cheques may be stopped by the banker at the instance of the following:

i) Notice of the customer's death.
ii) Notice of the customer's insanity
iii) Notice of the customer's bankruptcy
iv) Knowledge of any defect in the title of the person presenting the cheque.
v) Notice of an assignment by the customer of the available credit balance (on the receipt of such a notice, the customer's credit balance ceases to belong to him).
vi) Notice of a garnishee order
vii) In the case of trust accounts, knowledge that the customer contemplates breach of trust.
viii) In addition, a holder is not entitled to receive money unless the cheque is presented at the branch during business hours at which the customer's account is kept.

SELF-ASSESSMENT EXERCISE 4

Enumerate the circumstances under which a banker is justified in

refusing payment of a cheque drawn on him.

3.2.4 Protection Given to a Paying Banker

1. Crossed Cheques

Under Section 128 of the Negotiable Instruments Act, protection is given to a paying banker in the case of payment of crossed cheques. The Section runs as follows:

Where the banker on whom a crossed cheque has paid the same in due course, the banker paying the cheque, and in case such cheque has come into the hands of the payee, the drawee thereof shall respectively be entitled to the same rights, and be placed in the same position as they would respectively be entitled to and placed as if the amount of the cheque had been paid to and received by the true owner thereof.

This implies that protection is given to a paying banker in the case of crossed cheques, if he has paid in due course.

2. Uncrossed Cheques

Section 85 of the Negotiable Instruments Act extends protection to the paying banker in the case of uncrossed cheques. Here too, he is discharged by payment in due course. The Section runs as:

i) Where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course.

ii) Where a cheque is originally expressed to be payable to bearer; the drawee is discharged by payment in due course to the bearer thereof notwithstanding any endorsement whether in full or in blank appearing thereon, and notwithstanding that any such endorsement purports to restrict or exclude further negotiation.

3. Demand Drafts

The Act protects a paying bank in the case of demand drafts also. In terms of the Act:

Where any draft, that is, an order to pay money drawn by one office af a bank upon another office of the same bank for a sum of money payable to order on demand purports to be endorsed by or on behalf of the payee, the bank is discharged by payment in due course.

3.2.5 Payment In Due Course

The paying banker can claim protection only on payment in due course of a cheque or draft. Therefore, let us examine the meaning of the term 'payment in due course'.

In terms of Section 10 of the Negotiation Instruments Act:

Payment in due course means payment in accordance with the apparent tenor of the instrument, in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned.

Thus, in order to constitute 'payment in due course', the paying banker must see that the following conditions are fulfilled:

a) Payment must be in accordance with the apparent *Tenor of the Instrument*

In other words, payment must be in accordance with the intention of the parties as it appears on the face of the instrument. For instance, when the paying banker disregards the crossing and pays cash across the counter, the payment cannot be considered 'payment in due course'. Here the banker disregards the intention of the drawer by way of crossing appearing on the face of the instrument. Again, where a banker pays a postdated cheque before the ostensible date of issue, the payment cannot be considered a 'payment in due course'. Here again the paying banker disregards the intention appearing on the face of the instrument.

b) Payment must be in good faith and without negligence

The banker's negligence may be found in the case of payment of a cheque bearing a forged signature of the drawer, which clearly differs from the specimen signature supplied to him. Even when the signature of the drawer is cleverly forged and if it is similar to the specimen signature supplied to the paying banker in every respect, it depends on the circumstances of that particular case to conclude categorically whether he is liable for negligence.

It is for the customer to establish affirmatively that the signature on the disputed cheque is not that of the customer but a forgery. The following considerations are important:

i) If the drawer's signature is forged or unauthorized, however clever the forgery is, the banker cannot debit his customer's

account in case he pays the amount unless he establishes adoption or estoppels;

ii) What amounts to adoption or estoppel is dependent on the circumstances of each case;

iii) In order to make the customer liable for the loss, negligence on his part must be intimately connected with the transaction itself and must have been the proximate cause of the loss;

iv) The banker cannot set up either estoppel or adoption if his own conduct or negligence has occasioned or contributed to the loss, the well settled principle being that where two innocent parties must suffer for the fraud of a third party, he whose negligence facilitated the fraud should suffer.

In *Wealden Woodlands (Kent) Ltd. Vs National Westminster Bank Ltd,* the decision is that a bank which pays forged cheques cannot resist the customer's request for the amount to be credited on the grounds that the customer had failed to note the payment from its bank statement, and was therefore deemed to have adopted the payment.

The Learned Judge in the case, however, implied that the bank's defence might be available if the customer was in some way culpable. In the instant case also, a trusted director had forged the signature of another director on cheques over a period of 9 months.

Rejecting the bank’s claim that the customer was estopped from recovery payments on the forged cheques, the Learned Judge observed that the customer was under no obligation examine his bank statements, and that failure on the part of the customer to draw inferences from those statement would not constitute negligence on his part, so that could be estopped from claiming the amounts paid forged cheques from the bank.

c) Payment must be made under circumstances which do not afford a reasonable ground for believing that the person presenting the cheque is not entitled to receive payment of the amount mentioned therein

The paying banker, before making payment, should make sure that the person presenting the cheque is entitled to receive the amount. For instance, where the paying banker pay a cheque, the payment of which has been countermanded by the drawer, the payment cannot be considered ‘payment in due course even if the person presenting it is not the true owner, provided the banker pays it under circumstances which

do not afford a reasonable ground for believing that the person presenting it is not entitled to receive the amount.

3.2.6 Money Paid by Mistake

The following are important considerations in respect of money paid by mistake:

1. In a situation where a paying banker pays money by mistake, cannot recover the amount. If money was paid under, a mistake of law, the banker cannot recover it, as has been held in *Holt Vs Markham*. For instance, if a person pays a debt in ignorance of the law of limitation; the mistake is a mistake of law, and the money is not recoverable.

2. The underlying principle is that all persons are expected to know the law, and ignorance thereof is no defence in a Court of Law. But when money is paid under a mistake of fact, the banker has, in general, a right to recover the amount. However, it must be shown that the mistake was one of fact between the payer and the receiver, and the mistake arose out of the actual transaction between the payer and the receiver.

3. It may be pointed out here that if the person receiving the money was aware that he was not entitled to the money, the banker's right of recovery is of indisputable. Nevertheless, if the recipient acted *bonafide* and the banker does not find out the mistake until the recipient has altered his position, it appears that the banker cannot recover the money.

For instance, if money was paid to and received by an innocent party as an agent, and he, before receiving notice of the mistake, has transferred money to the principal, the banker's right altered. Another instance of alteration of the recipient's position can be found where postponement of notice to the recipient has prevented him from giving due notice of the dishonour to the persons liable on the instrument.

4. Money paid under a mistake of fact between the banker and the recipient cannot be recovered if it was paid to an innocent holder in respect of a negotiable instrument. However, the payment of a cheque bearing a forged signature followed by a genuine endorsement is made to an innocent holder; the banker has a right of recovery, provided the mistake is pointed out to the recipient at once, before his position may have been altered to his detriment.
5. When the mistake of fact lies between the banker and the drawer of a cheque, the banker cannot recover the money paid to an

innocent holder. For instance, where a banker discovers, after paying a cheque, that the drawer had no funds in his account, he cannot recover the money from an innocent holder, even if the latter has not left bank premises. The payment is complete as soon as the money is placed on the bank counter and the recipient has touched it. The mistake is not between the banker and the holder of the cheque.

6. Where a banker receives money from a third party for crediting to a customer's account and has credited the same in his account, the banker cannot, without the authority of the customer, reverse the credit entry made *in* the account and pay back the money to the person who has deposited it, even though he might have deposited it by mistake.

7. When the amount overpaid is received by the bank on behalf of a customer for crediting to his account, and has credited the same, it becomes money of the constituent. While the customer may be under liability to refund the money so credited, the banker cannot reverse the credit without the consent of the customer. Since it is received correctly for crediting the account of the customer, there is no mistake on the part of the bank in crediting this money to that account.

8. Payment of a stopped cheque in error. In case a paying banker pays a stopped cheque in error, he will have a right of recourse under the doctrine that payment was made under 'a mistake of fact', as was held *in Barclays Bank Ltd. Vs Simson & Cook Ltd.*

Exceptions to such right of recourse hold under the following circumstances:

a) Where payment was of a negotiable instrument which had been negotiated;
b) Where the payee has altered his position as a consequence of the payment;
c) Where the "mistaken fact" was not made as between the payer and the receiver; and
d) Where the fact was not material.

9. Payment of domiciled bills. When a drawee accepts a bill of exchange elsewhere than at his place of business or private address the bill is said to be domiciled at the place of payment. A banker is under no obligation to pay bills made payable at the bank by the customer, unless the banker has expressly or through implication agree to pay bills domiciled with him.

9. Basically, bankers take a mandate from the customer before agreeing to pay bills domiciled with him. This mandate includes an undertaking by the customer that he will not hold the banker liable in case the bill bears a forged endorsement. This is especially important since a banker has no statutory protection against forged endorsements on domiciled bills.

10. The conditions governing the payment of bills are, by and large, similar to those applicable to the payment of cheques. Therefore, the banker should satisfy himself regarding the correctness in form, regularity of endorsements, genuineness of the acceptor's signature, etc. However, it is not the duty of the banker to see whether the signature of the drawer is genuine. It is the duty of the acceptor to make sure that the signature of the drawer is genuine.

SELF-ASSESSMENT EXERCISE 5

Enumerate the important considerations in respect of money paid by mistake.

3.3 Collecting Banker

The Collecting Banker is one who undertakes to collect various types of instruments representing money in favour of his customer or his own behalf from the drawers of such instruments, some of which are negotiable instruments as provided for in the negotiable instruments Act.

3.3.1 Duties and Responsibilities of Collecting Bankers

1. Acting as agent

While collecting an instrument, whether for credit to customer’s account or for himself, the banker works as agent of his customer. As an agent he has generally to take such steps and precautions to protect the interest or his customer as a man of ordinary prudence would take to safe-guard his own interest.

2. Scrutinizing the instruments

This is in areas of name of the holder, branch name, date, amount in world and figure, any cutting without signature, material alteration of any to be checked carefully.

3. Checking the endorsement

Bankers has to check the instrument whether it has been endorsed properly.

4. Presenting the instrument in due time

It is the responsibility of the collecting bank to present the instrument in due time to the paying bank.

5. Collecting the proceeds in the payee's account

It is the duty of collecting banks to collect and credit the proceeds of the instruments to the proper/correct account.

6. Notice of dishonor and returning the instruments

If any instrument is dishonored by the paying bank it should be communicated to the customer on the business day following the receipt of the unpaid instruments.

SELF-ASSESSMENT EXERCISE 6

Enumerate the responsibilities of collecting bakers.

3.3.2 Collecting Banker's Protection

In terms of Section 131 of the Negotiable Instruments Act, a banker, while collecting crossed cheques, is given protection. According to this Section:

A banker who has in good faith and without negligence received payment of a cheque crossed generally or specially to himself shall not, in case the title of the cheque proves defective incur any liability to the true owner of the cheque by reason of having received such payment.

A banker receives payment of a crossed cheque for a customer within the meaning of this Section, notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof.

I) Conditions Precedent to Protection of Collecting Bankers include the following:

The above section protects a collecting banker when he collects a crossed cheque bearing a forged endorsement, or in respect of which the

customer has no title or a defective title. It may be noted here that to claim protection, the collecting banker must strictly comply with the provisions of the Section. These conditions are identified and discussed below.

1. The Collecting Banker Should Act in Good Faith and Without Negligence

The most important point for a banker to remember when he is collecting cheques is that he must act in good faith and without negligence. A thing is deemed to be done in good faith when it is done honestly. But Section 131 of Negotiable Instruments Act also requires him to act without negligence. Thus the question of negligence is important to decide whether or not a collecting banker can claim statutory protection.

Generally, it may be said that the question of negligence does not arise when the banker is dealing with third parties. Negligence arises only when there is a duty to act without negligence. In general, it may be stated that a banker owes no such duty to a third party. Nevertheless, the position of a collecting banker is different. As observed by Sir John Paget, the assumption of this duty towards a stranger must be regarded as part of the price paid by bankers for statutory protection. As such, in case of a dispute, the collecting banker has to prove that he has acted without negligence in order to get protection under the Act.

It is difficult to define the term 'negligence'. In W *Wall Bank & Co. Ltd Vs Westminster Bank Ltd.,* the Learned Judge observed that `negligence is the doing of that which a reasonable man under all the circumstances of the particular case in which he is acting would not do, or the failure to do something which a reasonable man under those circumstances would do. This definition does not convey a clear idea regarding the basis of negligence. The term `negligence' has been widely interpreted by the Courts. Hence it would be better to examine the term in the light of the various judicial decisions.

2. Examination of endorsements

The collecting banker must satisfy himself that all the endorsements on the cheque are regular. In *Bavins Junr and Sims Vs London and South Western Bank*, it was held that the collecting banker was negligent in not detecting that an endorsement and a signature to a receipt did not correspond with the name of the payee.

If the endorsement is *a per pro* endorsement, or an endorsement put on delegated authority, the banker is on enquiry as to the agent's power, and

collection of a cheque without authority may involve the banker in liability for any loss that may ensue, as was decided in *Bissel* & *Co. Vs Fox Brothers & Co.*

Relatedly, in *Crumplin vs The London Joint Stock Bank,* it was held that the words *per pro* and the fact that the bank did not make enquiries was not complete evidence of negligence on the part of the bank. However, to be on the safer side, it is advisable for the collecting banker to get a proper written authority in case of an endorsement made by an agent.

3. Collection of a cheque made payable to a company for the private account of an official endorsing the same

In *Savory vs Lloyds Bank,* it was held that the collection of a company's cheque for a private account without obtaining a satisfactory explanation would deprive the banker of statutory protection.

4. Collection of cheques drawn per pro on behalf of a firm and made payable to the person so signing

In *Midland Bank Ltd vs Reckit and Others,* it was held that the bank was negligent in not making enquiries before crediting, to the private account of an attorney, the proceeds of cheques drawn by him under his power of attorney.

Furthermore, in *Lloyds Bank Ltd vs Chartered Bank Ltd.,* the collecting banker was held guilty of negligence for the same reason. Here, the chief accountant of Lloyds Bank drew certain cheques under authority and made them payable to the Chartered Bank, where he had a private account. The cheques were handed over to Chartered Bank for collecting them to his private account.

5. Collection of cheques payable to a partnership firm for the private account of a partner

In *Bevan Vs National Bank Ltd* it was held that the collecting banker was guilty of negligence in collecting cheques made payable to a partnership firm for the private account of a partner.

6. Collection of cheques payable to a customer in his official capacity for his private account

For instance, a cheque made payable to `Mr Gupta, Income Tax Commissioner' should not be collected for the private account of Mr Gupta.

7. Collection of cheques where the customer is the endorsee and not the payee (third party cheques)

In collecting such cheques, the collecting banker should be extremely careful to safeguard the interests of the true owner. The collecting banker would be held liable for negligence if he fails to verify the genuineness of the endorsement of the payee.

Section 10 and 85 (1) of the Negotiable Instruments Act provides that in view of the guarantee given by the collecting banker as to the reliability of the endorsement, the bank would be justified *ex facie* in accepting it and acting on that basis.

The collecting banker should take the least precaution to verify endorsement of a cheque. In *United Australia vs Barclays Bank Ltd.*, Lord Atkin observed that "in these days every bank clerk sees the red light when a company's cheque is endorsed by a company official into an account which is not the company's".

This not only applies to cases of companies or persons standing in a fiduciary position, but also to cheques drawn in favour of an incorporated company which has purportedly endorsed the cheque in favour of another incorporated company due to the reason that every credit and debit by cheques, for or against, is normally expected to find a place in the accounts, and the usual way a company acts, is that when it receives, it also makes payment by cheques and not through endorsement, as in this case.

The Court considered decided cases in Lloyds Bank Ltd Vs Savory and Co., Motor Trader Guarantee Corporation Vs Midland bank ltd held that the question of good faith and negligence was a question of fact in the light of the material in each case. In the instant case, the collecting banker had not shown that he had acted in good faith and without negligence in making the collection on the basis of the guarantee of the forged endorsement.

7. Collection of cheques involving large amounts incompatible with the customer's income, for his private account

In the case of *Lloyds Bank Ltd. vs Chartered Bank Ltd.,* it was held that the absence of enquiry on the source of a sudden increase in payment was negligence on the part of the collecting banker. In the instant case, a clerk of the plaintiff bank was entrusted with defendant bank, for the credit of a small joint account of himself and his wife, bank drafts for large amounts drawn in favour of Lloyds Bank. In such cases, it would be advisable for the collecting banker to make reasonable enquiries. His

failure to make reasonable enquiries, coupled with other circumstances, may be considered as evidence of negligence.

8. Collection of cheques endorsed to the customer without obtaining guarantee for the endorsement of the payee

Where a banker had collected cheques endorsed to his customer without obtaining guarantee for the endorsement of the payee, he would be held liable for negligence.

A banker should always take care to ask the payee the truth about the endorsement made by customers to know the true payees of cheques and drafts of their customers before making payments.

9. Alleged contributory negligence of the true owner is not a defence for negligence of the collecting banker

However negligent the true owner may be, it can be no excuse for the person who converts the article that he should be let off from his liability due to negligence by the true owner. Nevertheless, negligence should not be confused with the plea of estoppels.

In this consideration, the details of *Lumsden and Co. vs London Trustee Savings Bank* would be of interest since it is the first reported case in which it has been held that when awarding damages against a collecting bank in respect of the conversion of the proceeds of cheques paid in by a customer, to which the customer was not entitled, it is proper to take into account the plaintiff's own negligence. As a result, the loss may be apportioned between the plaintiff and the defendant bank.

10. Reference for the respectability of a new customer

Negligence of a collecting banker may refer back to the opening of an account. In other words, if the collecting banker fails to make satisfactory enquiries about a customer at the time of opening of an account in his name, he may be held guilty of negligence. As far back as 1903, it was held in *Turner vs London and Provincial Bank Ltd.* that carelessness in opening an account was one of the circumstances of the collecting banker's negligence. The decision was similar in *Ladbroke Vs Todd.* Here, the bank failed to make satisfactory references regarding the position or character of the customer before opening an account in his name, and was subsequently held guilty of negligence. Of course,

Nevertheless, in *Commissioners of Taxation Vs English, Scottish and Australian Bank,* the bank successfully contested liability in spite of apparent absence of enquiry regarding its customer. In the instant case,

the Learned Judge observed: *"it is not a question of negligence in opening an account, though the circumstances connected with the opening of an account may shed light on the question of whether there was negligence in collecting a cheque".*

The observations made by the Learned Judge in the case of *Lumsden and Co. vs London Trustee Savings Bank,* referred to earlier, may also be noted in this connection:

...in the unsatisfactory position of a customer and a referee both newly arrived from abroad and to that extent liable to be more of an unknown entity, no attempt was made to obtain independent confirmation of Brown's identity by, for example, a request for the production of his passport. Last, but by no means least, there was the failure to enquire further when Dr Blake failed to give any banker as a referee despite an express and very necessary request for this information. This above all facilitated the assumption of a fictitious personality, buttressed by a fraudulent reference.

11. Collection of cheques crossed 'account payee' for persons other than the payee named

A cheque crossed 'account payee' should be collected only for the account of the payee named, as was held in *Akrokerri (Atlantic) Mines Ltd. vs Economic Bank* and *Morrison Vs London County and Westminster Bank Ltd. Again. In Underwood (AL.) Ltd. Vs Bank of Liverpool and Martins,* it was observed that while this addition did not affect the negotiability of an order or bearer cheque' yet, when such a cheque was paid into the account of a person who was not the payee, the banker should be put on enquiry. However, where a banker is collecting such a cheque for another banker, he cannot be expected to make such enquiries.

12. Collection of cheques crossed 'not negotiable'

According to certain quarters, a collecting banker is guilty of *negligence* when he collects cheques crossed 'not negotiable' for someone other than the payee concerned. However, in *Penmount Estates Ltd. Vs National Provincial Bank Ltd.,* it was held that the bank was not guilty of negligence in crediting to a solicitor's account a 'not negotiable' crossed cheque payable to a third party. Further, in the case of *Crumplin Vs London Joint Stock Bank Ltd.,* it was held that a 'not negotiable' *crossing* is merely one factor among others to be considered in deciding whether the collecting banker had been negligent, and in the circumstances of the instant case, there had been no negligence.

13. Collection of 'not transferable' cheques

A collecting banker is guilty of negligence when he collects a 'not transferable' cheque for any person other than the payee. For instance, a cheque payable to Shonibare Ojoba should be collected only for the account of Shonibare Ojoba.

II. Protection only for Crossed Cheques

Protection under Section 131 applies only to cheques crossed before they reach the collecting banker. If the cheque is crossed by the collecting banker, he cannot claim protection, and may be held liable to the true owner in a suit for conversion. Hence it is always advisable for him to require his customers to cross all cheques paid in for collection.

III. Cheques Should be Collected for a Customer

Section 131 applies only to crossed cheques collected for a customer. Therefore, if the banker collects cheques for any person other than a customer, he cannot claim protection, and he will be held liable to the true owner in case the title of the person for whom he collects the cheques proves defective.

Here a question arises as to whether or not the banker can claim protection when he has received Payment of a crossed cheque for himself as a 'holder for value'. In terms of Section 131, the banker can claim protection only when he has received payment for a customer. Nevertheless, where a banker collects a cheque payable to himself, but accompanied by a direction that the proceeds should be credited to a customer, he receives payment for a customer, as was decided in *Lloyds Bank Ltd. Vs Chartered Bank Ltd.* But in a situation where the banker takes a cheque as an independent holder, he cannot claim protection, for instance, if the collecting banker pays cash across the counter and collects the cheque later on. Here the banker is collecting the cheque for himself, and as such, he is precluded from claiming protection.

Explanation given to Section 131 of the Negotiable Instruments Act clearly lays down that a banker can claim protection notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof. But the banker should not allow the customer to draw against the amounts of such cheques before receiving payment. By mere crediting of such cheques as cash does not give the customer an immediate right to draw against the items. There must be, in addition, some definite agreement, express or implied, that the customer may draw against such cheques before clearance, as was decided in *Underwood Vs Barclays Bank Ltd.*

IV) Banker as a Holder for Value

There are certain instances when the banker can undoubtedly be considered a holder for value. The following instances have been pointed out by Sheldon, where the banker is collecting the proceeds of a cheque for himself, and not receiving payment for a customer:

i) When the banker gives cash in exchange for a cheque drawn on another banker.
ii) When the banker credits his customer with the amount of the cheque as soon as it is paid in, and allows him to draw at once against the amount.
iii) When the cheque is expressly paid to reduce the amount of an overdraft.

V) Collection of Bills

The legal protection given to a collecting banker applies only in the case of collection of crossed cheques. Hence, while collecting a customer's bills of exchange, the banker does not get this protection. He may be held liable for collecting a bill on which the customer's title proves defective. A banker may further be held liable if he fails to perform his duties in connection with presentment for acceptance and payment of bills.

VI) Collecting Banker and Presentment for Acceptance

When a banker receives an unaccepted bill for presentation on behalf of a customer, he should present it for *acceptance* as early as possible. This is advisable in his own interest because, on acceptance, he obtains an additional security, and if acceptance is refused, he can initiate legal action against the parties concerned wherever such a course is applicable, for example, in the case of a discounted bill.

Furthermore, the banker is expected to exercise reasonable care and skill in safeguarding his customer's interests. Thus, if the customer suffers a loss owing to the banker's failure to present a bill for acceptance or for payment, the banker may be held responsible. Wherever possible, the banker should present the bill on the day of receipt itself. Where this is not possible, it must be presented within a reasonable time. In this connection, the Rule regarding excuse for delay in presentment for acceptance (or payment) may be mentioned.

According to of Section 75 of Negotiable Instruments Act:

Delay in presentment for acceptance or payment is excused if the delay is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct or negligence. When the cause of delay ceases to operate, presentment must be made within a reasonable time.

It may be noted that the banker must not take a qualified acceptance without the consent of his principal.

VII) Rules Regarding Presentment for Acceptance

Section 61 of the Negotiable Instruments Act lays down the provisions governing presentment for acceptance. In terms of this Section:

1) A bill of exchange payable after sight must, if no time or place is specified therein for presentment, be presented to the drawee thereof for acceptance, if he can after reasonable search, be found, by a person entitled to demand acceptance, within a reasonable time after it is drawn, and in business hours on a business day In default of such presentment, no party thereto is liable thereon to the person making such default.

2) If the bill is directed to the drawee at a particular place, it must be presented at that place; and if at the due date for presentment he cannot, after reasonable search be found therein, the bill is dishonoured.

3) Where authorized by agreement or usage, a presentment through the post office by means of a registered letter is sufficient."

Presentment for acceptance is excused *where* the drawee cannot be found after reasonable search, or where the drawee is a fictitious person, or where the drawee is incapable of contracting, or where, although presentment is irregular, acceptance has been refused on some other grounds.

Bills payable on demand, or on a fixed date, need not be presented for acceptance. But presentment for acceptance is necessary in the case of:

(a) a bill payable after sight; and
(b) a bill in which there is an express stipulation that it shall be presented for acceptance before it is presented for payment.

However, as mentioned earlier, it is always desirable to get a bill accepted as early as possible even when presentment for acceptance in optional.

VIII) To whom Bills should be presented for Acceptance

The banker should present a bill for acceptance to:

1) The person directed to pay the bill (i.e., drawee) or his authorized agent.
2) All the drawees, in case there are several drawees, unless any one of them has the proper authority to accept it on behalf of all.
3) The legal representatives, if the drawee is dead.
4) The Official Receiver, if the drawee has been declared an insolvent.

Where a bill is addressed to more than one drawee, the banker should present it to each of the drawees, unless one has proper authority to accept it on behalf of all. Otherwise, the bill binds only those who accept it. When a bill is dishonoured by non-acceptance, the banker should immediately return it to the customer.

IX) Collecting Banker and Presentment for Payment

It is the duty of the collecting banker to present a bill entrusted with him for collection according to the rules laid down in the Negotiable Instruments Act. The relevant provisions are as follows.

1. Promissory notes, bills of exchange and cheques must be presented for payment to the maker, acceptor or drawee thereof respectively, by or on behalf of the holder as hereinafter provided. On default of such presentment, the other parties thereto are not liable thereon to such holder. Where authorized by agreement or usage, a presentment through post office by means of a registered letter is sufficient. *(Section 64)*

2. Presentment for payment must be made during the usual hours of business, and, if at a banker's, within banking hours. *(Section 65)*

1. A promissory note or bill of exchange made payable at a specified period after date or sight thereof must be presented for payment at maturity. *(Section 66)*

4. A promissory note, bill of exchange or cheque made, drawn or accepted payable at a specified place and not elsewhere must, in order to charge any party thereto, be presented for payment at

that place. *(Section 68)*

5. A promissory note or bill of exchange made, drawn or accepted payable at a specified place must, in order to charge the maker or drawee thereof, be presented for payment at that place. *(Section 69)*

6. A promissory note or bill of exchange not made payable as mentioned in Sections 68 and 69 must be presented for payment at the place of business (if any), or at the usual residence of the drawee or acceptor thereof, as the case may be. *(Section 70)*

7. If the maker, drawee or acceptor of a negotiable instrument has no known place of business or fixed residence and no place is specified in the instrument for presentment for acceptance or payment, such presentment may be made to him in person wherever he can be found. *(Section 71)*

8. Subject to the provisions of Section 31, a negotiable instrument must be presented for payment to the authorized agent of the drawee, maker or acceptor. as the case may be, or where the drawee, maker or acceptor has died, to his legal representative, or where he has been declared insolvent, to his assignee. *(Section 74)*

9. Delay in presentment for acceptance or payment is excused if the delay is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct or negligence. When the cause of delay ceases to operate, presentment must be made within a reasonable time. *(Section 75* A)

10. No presentment for payment is necessary, and the instrument is dishonoured at the due date for presentment, in any of the following cases:

(a) if the maker, drawer or acceptor intentionally prevents the presentment of the instrument, or, the instrument being payable at his place of business, he closes such place on a business day during business hours, or if the instrument is payable at some other specified place, neither he nor any person authorized to pay it attends at such place during the usual business hours, or if the instrument not being payable at any specified place, he cannot be found after due search;

(b) as against any party sought to be charged therewith, if he has engaged to pay notwithstanding non-presentment;

(c) as against any party, if, after maturity, with knowledge that the instrument has not been presented, he makes a part payment on account of the amount due on the instrument, or promises to pay the amount due thereon in whole or in part, or otherwise waives his right to take advantage of any default in presentment for payment;

(d) as against the drawer, if the drawer could not suffer damage from the want of such presentment.(Section 76)

8. When a bill of exchange accepted payable at a specified bank has been duly presented there for payment and dishonoured, if the banker so negligently or improperly keeps, deals with or delivers back such bill as to cause loss to the holder, he must compensate the holder for such loss. *(Section 77)*

4.0 CONCLUSION

From our discussion in this unit, we have stated that a paying banker has responsibility in paying the customers on the strength of instruments presented while the collecting banker ensures that it collects proceeds of instrument on behalf of the customers. In the process of performing such duties for the customers, the bankers have to observe the relevant legal obligations so that they can be protected by the law as established in the Negotiable Instruments Act.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed bankers in respect of their position towards their customers and such analysis borders on: paying bankers' duties and responsibilities; important considerations for payment of cheques; circumstances under which a banker is justified in refusing payment of a cheque drawn on him; protection given to a paying banker; payment in due course; money paid by mistake; collecting banker; duties and responsibilities of collecting bankers; and collecting banker's protection. In the next study unit, we shall discuss relationships with limited liabilities companies.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Differentiate between a Paying Banker and a Collecting Banker.
2. What are the forms of protection available to a banker while collecting crossed cheques, according to Section 131 of the Negotiable Instruments Act.

7.0 REFERENCES/FURTHER READING

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UNIT 3 BANK LENDING TO LIMITED LIABILITIES COMPANIES

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we discussed the duties and responsibilities of paying and collecting bankers regarding dealing with their customers, which include corporate bodies. In the same vein, banks do deal with limited liability companies in area of lending of funds for the corporate bodies' operational needs. In this study unit, therefore, we shall also espouse on various forms of loans and advances being offered by banks to corporate bodies.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- mention and discuss the principles of bank lending
- list and discuss methods of granting advances.

3.0 MAIN CONTENT

3.1 Principles of Bank Lending

There are some precautions to be taken by a banker, and the principles to be taken into consideration while granting advances to corporate bodies. In this section of the study unit, the discussion is on the general principles to be borne in mind by a banker while granting advances.

1. Liquidity

Liquidity implies the ability to produce cash on demand. A bank mainly utilizes its deposits for the purpose of granting advances. These deposits are repayable on demand or on the expiry of a specified period. In either case, the banker must be ready to meet these liabilities whenever necessary. As such, he has many outstanding contracts for the future delivery of money. In case of failure, he will suffer in his credit, which can affect the very foundation of bank. There will be operational shock of such a failure, but it will also be transmitted to the other links of the banking system, thereby precipitating nation-wide bank failures.

Nevertheless, the presence of the deposit insurance system tends to minimize the danger of panicky withdrawals. However, the banker should always bear in mind that he is the guardian of a very delicate mechanism which paves the way for future economic development of the country and any failure and bank run by customers will create monetary disequilibrium with all the grave implications for the economy and the country's monetary system.

Hence the importance of ensuring that the advances granted by the banker are as liquid as possible cannot be over-emphasized. Advances granted by a banker by way of discounting first class bills of exchange satisfy this principle of "shiftability". The apex bank of the country extends rediscounting facilities to first class bills, and this enables the banker to obtain funds in case of emergencies. In some other cases, "shiftability" principle may not be readily available. Nevertheless, bankers can insist on securities which are shiftable without loss, in order to cover the advances granted such as the government securities.

2. Profitability

Banks essentially operate as commercial ventures. The fact is that excessive and unjustifiable profits can only be at the cost of the customer, insofar as higher lending rates push up production costs, and in the ultimate analysis, adversely affect society in general. At the same time, the fact remains that while strong operating profits allow for full prudential provisioning, high net profits allow for allocation to capital and reserves, which is essential for any bank to maintain its competitive viability and expand its lending operations. Furthermore, the shareholders of a bank are entitled to reasonable dividends. In addition, the depositors have to be compensated with reasonable returns on their deposits. All this implies that it is necessary for the banks to make sure that their lending operations are sufficiently profitable.

3. Safety and Security

Banks are supposed to ensure that the borrower has the ability and will to repay the advances as per contractual agreement. Relatedly, before granting a secured advance, banks should carefully consider the margin of safety offered by the security concerned and possibilities of fluctuations in its value. When it is an unsecured advance, its repayment depends on the creditworthiness of the borrower, and that of the guarantor, wherever applicable. As such, the fundamental principles which the banker should consider in the case of unsecured advances are Character, Capacity and Capital (the popular Cs of lending), which have been decoded as in other terms as Reliability, Responsibility and Resources (known as three Rs) of the borrower and the guarantor.

4. Purpose

Banks are to carefully examine the purpose for which the advance has been applied for. In case the advance is intended to be utilized for productive purposes, it could be reasonably anticipated that cash flows arising from such productive activities will result in prompt repayment. However, the banker has to be careful to monitor the exact purpose for which the advance is actually utilized. There is always the possibility that the advance, once granted, may be diverted for purposes other than that indicated by the borrower at the time of application. Thus, there should be proper provisions for effective post credit supervision.

5. Social Responsibility

Regardless of the major preoccupation of the banks as essentially commercial ventures, banks should not forget the fact that it is not enough that only corporate bodies of means that are granted bank credits and loans. The important thing is that through productive effort bank finance should make enterprises creditworthy, and turn them into body corporate of means. Hence, technical competence of the borrower, operational flexibility and economic viability of the project rather than the security which the borrower can offer, should be considered in evaluating a loan proposal.

Identification of priority sectors in the economy for the purpose of extending bank credit should be considered as a positive development in the banking system, aimed at effectively discharging bank's responsibility towards the society; in line with the apex bank's (CBN) directive on sectoral allocations of credits with priority to agriculture and the SMEs. However, social responsibility pre-occupation should not deter the banks from paying adequate attention to the qualitative aspects of lending.

6. Industrial and Geographical Diversification

Banks should also aim at spreading the advances as widely as possible over different industries and different localities in line with spartial distribution of industries and regional development. Relatedly, the essence is enable the banks to compensate any losses which might arise as a result of unanticipated factors adversely affecting particular industries and particular localities. Hence, banks with viable branches are in a favourable position to discharge this responsibility effectively.

SELF-ASSESSMENT EXERCISE 1

Explain bank lending in relation to the relationships that exist between banks and limited liability companies.

3.2 Methods of Granting Advances

The main methods of granting advances may be classified as: Cash Credits; Overdrafts; Bills Discounting; Issuance of Letters of Credit; and Loans. All these are discussed as follows.

1. Cash Credit

Under cash credit method, the banker allows the customer to borrow up to a certain amount. Under this arrangement, the borrower is required to provide security in the form of pledge or hypothecation of tangible securities. In some cases, the limit is granted on the guarantees furnished by sureties acceptable to the banker. Basically, it is not necessary for the borrower to avail of the full cash credit limit in one installment. The borrower can avail of the facility according to his requirements subject to the condition that the total amount availed should not exceed the granted limit. The borrower is also allowed to credit any surplus cash in his possession.

Interest is charged only on the amount actually utilized by the customer. But banks considers it as losing interest on the unutilized funds since the entire cash credit limit is placed at the disposal of the customer irrespective of whether the beneficiary utilizes it or not. To compensate this, it is usual for the banks to incorporate a 'minimum interest clause' in the agreement with the customer in terms of which a certain rate of interest is payable on the unutilized portion of the cash credit limit.

2. Overdrafts

Overdraft facility involves granting advances over and above credit balances in the accounts of the corporate entities. In order to enjoy an

overdraft facility, the borrower has to have an existing current account. Hence, account is allowed to be overdrawn up to a certain limit. The borrower has to pay interest only on the amount actually overdrawn and only for the period during which it is utilized. Similarly, the interest chargeable on the facility depends on negotiation between the bank and the customer.

At the end of the financial year, the borrower is required to wipe off the debit balance in the current account, that is, the account has to be brought back to credit balance; but it also depends on the period of the overdraft. Thus, an overdraft is a short term credit facility. However the facility is usually renewed after the utilization of the previous one or at the beginning of the next financial year. This 'rolling over' practice has the effect of an overdraft providing at least medium term credit facility to the customer.

3. Bills Discounting

This window of opportunity for a facility or granting advances is also a short term facility intended to provide loanable funds or current working capital. Herein, the banker advances money on the security of bills of exchange after deducting a certain percentage, technically known as 'discount', from the face value of the bill. The deduction in terms represents interest on the loanable facility. This provision of financial accommodation is heavily favoured by conservative bankers according to whom the earning assets of a commercial bank should consist mainly of short term self-liquidating productive loans.

Such bill from a reputable company is considered as genuine commercial bill of exchange, and it is regarded to be a self-liquidating paper since it liquidates itself automatically out of the sale of the goods covered by such a bill. Furthermore, besides discounting of bills of exchange, a bank also purchases such bills outright at face value from their customers, less bank charges. Such purchase of bills is normally confined to bills payable on demand.

4. Issue of Letters of Credit

The use of the letters of credit is related to international trade, that is, trade between countries for financing the transactions. According to the International Chamber of Commerce, a letter of credit is:

Any arrangement however named or described whereby a bank (the issuing bank) acting at the request and in accordance with the instructions of a customer (the applicant of the credit) is to make payment to or to the order of a third party (the beneficiary) or is to pay

accept or negotiate bills of exchange (drafts) drawn by the beneficiary, or authorize such payments to be made or such drafts to be paid, accepted or negotiated, by another bank, against stipulated documents and compliance with stipulated terms and conditions.

Hence, when a stipulation is incorporated in the sale contract that the goods shall be paid by a banker's letter of credit, the seller need not worry whether the goods will be cleared by the buyer on arrival at the destination, and the buyer need not lock up his funds by making payment in advance. Basically, a commercial letter of credit substitutes the creditworthiness of the importer by the creditworthiness of the banker issuing the letter of credit, since it is a promise by the bank to pay or accept the bill, provided the exporter (the beneficiary) fulfills the terms and conditions set out in the credit.

I) Parties to a Letter Of Credit

The parties to a letter of credit are identified and discussed as follows. The parties to letter of credit include the buyer, the beneficiary, the issuing bank, the notifying bank, the negotiating bank, the confirming bank and the paying bank.

i) **The buyer** as the importer applies to the bank for opening a letter of credit. The bank may or may not require the buyer to secure the letter of credit by providing sufficient deposits/acceptable securities to protect its own interests. It depends on the confidence that the bank has over the buyer applying for the letter of credit.

ii) **The seller** as the exporter is the beneficiary of the letter of credit. The bank issuing the letter of credit assures the seller that the conditions of the credit will be met provided the relevant documents are produced and the terms and conditions set out in the credit are strictly complied with.

iii) **The bank** which issues the letter of credit at the request of the buyer is the issuing bank. The issuing bank must be well known and acceptable to the seller. The buyer gives instructions regarding the terms and conditions of the credit.

iv) **The notifying bank is the correspondent bank** that is situated in the same place as the seller, and advises the credit to the seller. But by notifying bank does not commit itself to any liability under the credit. Generally, the services of a notifying bank are utilized when the credit is advised to the seller through a cable message. Such a message will be in code language and the

notifying bank authenticates the message by decoding it.

v) **The negotiating bank** is the bank which negotiates the bills or drafts under the letter of credit. Generally, the same bank will act as the notifying bank and the negotiating bank. The negotiating bank has to see that the documents negotiated conform strictly to the terms and conditions of the credit.

vi) **The Confirming Bank**: Basically, the seller insists that the credit must be confirmed by a bank in his own country. Such a bank is known as the confirming bank. The advantage of this confirmation from the point of view of the seller is that he is assured of the payment as soon as the documents are presented at his own centre. The primary liability lies with the confirming bank, provided the seller fulfills the terms and conditions of the credit. As far as the seller is concerned, he can proceed against either the confirming bank or the issuing bank or both.

vii) **The paying bank** is the bank on which the bill or raft is drawn. It can be the issuing bank, the notifying bank or the confirming bank.

SELF-ASSESSMENT EXERCISE 2

Mention and explain parties to a Letter of Credit.

II) Credit contract between the buyer and the issuing bank, and sale contract between the buyer and the seller

A credit contract between the buyer and the issuing bank should be clearly distinguished from a sale contract between the buyer and the seller. A letter of credit is independent of, and unqualified by, the contract of sale or underlying transaction. Therefore, there is no obligation on the part of the issuing bank to ensure strict performance of the terms and conditions of the sale contract between the buyer and the seller. The issuing or confirming bank only has to see that it adheres strictly to the terms and conditions laid down in the letter of credit application.

III) Irrevocable letter of credit and bank guarantee

Opening of a confirmed letter of credit constitutes a bargain between the bank and the vendor of the goods, which imposes upon the bank an absolute obligation to pay irrespective of any dispute there might be between the parties as to whether the goods are up to the contract or not. The letter of credit is independent of and unqualified by, the contract of

sale or underlying transaction. A vendor of goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price. Payment under the irrevocable letter of credit does not depend on the performance of obligation on the part of the vendor except those which the letter of credit expressly imposes.

On the other hand, a bank guarantee has a dual aspect. It is not merely a contract between the bank and the beneficiary of the guarantee; it is also a security given to the beneficiary by a third party In seeking to enforce a bank guarantee, the beneficiary of the guarantee, in effect, seeks to realize the security furnished by the third party, and the party has, therefore, *locus standi* to challenge the enforcement of the guarantee. Unless there is some act of omission or commission on the part of the third party, payment of a bank guarantee does not become due.

IV) Uniform Customs and Practice

In order to avoid difference in interpretation of letter of credit terms, the International Chamber of Commerce has formulated a set of rules to guide banks in the use of documentary letter of credit. Although the first attempt in this direction was made as early as 1933, the latest version is contained in Publication No. 290 which came into operation from 1st October 1975.

It is instructive to note that the 'Uniform Customs and Practice' for documentary credit is not a law as such. The parties have voluntarily to apply the set of rules. But banks in many countries around the world adhere collectively to the rules laid down in Uniform Customs and Practice'. Banks in some other countries adhere individually to them. Banks in these countries expressly state that letters of credit issued by them are in accordance with Uniform Customs and Practice, Publication No. 290.

5. Loans

Loan as a term is popularly used to designate the granting of an advance in lump sum, generally on the basis of securities acceptable to the banker. The distinguishing feature of a loan is that interest on it is payable on the entire amount, whether it is fully utilized or not. It is granted for a definite period and the borrower is given the facility to repay it in one lump sum or in installments. To the banks, the operating cost of a loan is lower as compared to a cash credit or an overdraft. This method of granting an advance has the advantage of strengthening the financial discipline in the use of bank credit because it involves follow up, supervision and control as being made more effective as compared to cash credits and overdrafts.

SELF-ASSESSMENT EXERCISE 3

Mention and explain types of credits that bank make available to limited liability companies.

4.0 CONCLUSION

From our discussion in this unit, we have identified and discussed principles of bank lending to corporate bodies which include liquidity, profitability, security, and purpose, among others. Forms of lending to corporate bodies include loans, overdraft, discounting and purchasing bills of exchange, and issuance and honouring of letters of credit.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed bank lending to limited liability companies and in the process we have analyzed principles of bank lending and methods of granting advances. In the next study unit, we shall discuss securities and loan recovery.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is bank lending, and what are the principles guiding such banking operations?
2. What are the various types of bank lending facilities available for the use of corporate entities for enhancing their operations?

7.0 REFERENCES/FURTHER READING

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UNIT 4: SECURITIES AND LOAN RECOVERY

CONTENTS

1.0 INTRODUCTION

In the last study unit, we discussed bank lending to limited liabilities companies. Secured Loans are loans that are backed by collateral securities as pledged by the loan beneficiaries. This is because banks as lenders of funds always require some securities which are often called (collateral) to safeguard their funds. These collaterals could be in form of a building, land, share certificate of a reputable company. Personal assets like cars and jewelries, as well as letter of set-off. Therefore, the discussion in this unit revolves around the issue of securities for secured advances by banks to their customers.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- Discuss securities and loan recovery
- Mention and discuss types of property for collateral security
- List and explain types of valuables for collateral security
- Discuss personal guarantee in place of security

3.0 MAIN CONTENT

3.1 Securities and Loan Recovery

The issue of collateral security for loans from the commercial banks is very pertinent in securing such credit facilities by enterprises. The pledge of collateral security gives the bank as lender the right to seize and sell the assets designated as loan collateral, using the proceeds of the

sale to offset the outstanding funds which the borrower could not pay back.

The use of collateralization for a loan gives the bank as lender a satisfactory leverage or advantage over the borrower. This is due to the fact that when specific assets may be at stake, a borrower would feel more obligated to strive hard to repay the fund involved in loan facility and thus avoiding losing the valuable operational assets.

The basic purpose for banks' desire to insist on taking collateral security is to enable them to precisely identify which borrower's assets are subject to seizure and sale. It is important in using the device to document for all other creditors to believe that the bank has a legal claim to those assets in the event of non-performance on a loan.

It is used to ensure the safety of the funds committed into loan facility by the bank; the funds which actually belong to depositors. For these reasons banks do not comprise the issue of collateral security when considering lending their funds to business entities.

Therefore, in this chapter the analysis is focused on the various types of property that can be accepted by the commercial banks as collateral security by entrepreneurs and business entities before they can secure loan facilities.

SELF ASSESSMENT EXERCISE 1

Discuss securities in relation to loan recovery.

3.2 Property for Collateral Security

Collateral security is the property that is pledged by a loan beneficiary towards securing the facility. There are basic types of property that the banks normally insist on taking as collateral security for loan facilities. These are identified and discussed below.

1. Real Estate

A real property is acceptable in the consideration for a collateral security on a loan facility. Once the property is accepted by the bank, the bank can put public notice of a mortgage against a real estate. The bank then takes action to file with the relevant authority the pledge of the property for a loan facility from the beneficiary.

In some instances, the bank may have to take out title insurance and equally insists that the borrower purchases insurance policy to cover any

future damage from environmental hazards and perils. The bank receives a first claim on any insurance settlement that is made on the policy.

The bank will initiate action to determine the real value of the property once it accepts to advance some funds on loan facility to a borrower. The basic approaches to the valuation of real estate include the following.

i. **Cost approach**:- this involves considering the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land.
ii. **Market Data** or direct sales comparison approach:- this involves estimating the value of the subject property based on the comparable properties' current selling prices.
iii. **The income approach**:- this involves the use of discounted value of the future net operating income streams from the property.
iv. **The direct capitalization approach**:- this involves the calculation of the value by dividing an estimate of its average annual income by a factor called capitalization rate.

2. Personal Property:

The practice is for the banks to accept and take a security interest in items of property such as motor vehicles, machinery, equipment, furniture, securities, and other forms of personal property owned by a borrower.

Once it is accept as a collateral security, a financing statement will be filed by the bank publicly in those cases where the borrower keeps possession of any personal property pledged. This requires a pledge agreement to be prepared may be prepared if the bank or its agent holds the pledged property. This agreement will give the bank the right to control that property until the loan is repaid in full.

SELF ASSESSMENT EXERCISE 2

Mention and discuss different types of property for collateral security.

3.3 Valuables for Collateral Security

1. Personal Guarantees

The banks may also accept the pledge of the stock, deposits, or other personal assets held by the major stockholders or owners of a company. The borrower will be required to provide agreement on such pledge and

acceptance between the representative of the borrower and the bank as may be required for the collateral to secure a business loan for the entity.

The practice is that guarantees are often requested for by the banks in the cases of lending funds to smaller businesses. This is also required from corporate entities that have fallen on difficult times. The simple reason is that the arrangement will give the owners the prod or considered reason to strive harder so that their firm will prosper and repay their loan.

2. Accounts Receivable

Another practice is that the banks can accept and take a security interest in the form of a stated percentage of the face value of accounts receivable, which involves value of sales on credit, as shown on a business borrower's balance sheet.

Whenever the borrower's credit customers send in cash to settle their outstanding debts, such funds or cash payments are applied for the settlement of the outstanding balance of the borrower's loan. This may to take the form of mortgaging the receipts of the accounts receivable so that the payment would be made to the account opened for such money in the bank’s domain.

The banks often take the necessary measures to evaluate accounts receivable pledged for the loan facility by the borrower. The main types of method of evaluation of accounts receivable are accounting receivable aging and accounting receivable turnover.

3. Factoring

The banks can also purchase the borrowers’ accounts receivable. The arrangement is that the agreement will be based upon some percentage of the book value of such debtors. The factoring interest is the difference between the book value and the discounted value of the accounts receivable.

The borrower's customers who are the debtors would be required to make payments direct to the purchasing bank, which happens to the lender of funds to the firm whose debts the bank has acquired. The agreement will incorporate the consideration that the borrower promises to set aside some funds with which to cover some or all of the losses that the bank may suffer from any unpaid receivables.

4. Inventory

In this consideration, a bank will lend only a percentage of the estimated market value of the borrower's inventory, which serves as the collateral security for the loan facility. The bank could have a floating lien in the sense that the inventory pledged may be controlled completely by the borrower.

In the case of the floor planning, the lender takes temporary ownership of any goods placed in inventory and the borrower sends payments or sales contracts to the lender as the goods are sold. This arrangement ensures that the bank as the lender is rest assured that he has a proper lien on the inventory.
The practice requires that the bank evaluate the inventory. The basic ways to evaluate the inventory include resale of inventory, inventory turnover, and inventory converted to accounts receivable.

SELF ASSESSMENT EXERCISE 3

List and explain various types of valuables for collateral security.

3.4 Personal Guarantee In Place Of Security

In the case of the usage and accessibility of guarantees and security depend on the form of credit being granted or offered by the bank. In some instances, bank lending tends to be securitized but in the case of corporate credit, such may be very exceptional. This is due to the dictates of the market forces of demand and supply of funds. Besides common practices also contributes to such scenario.

The normal practice is that a bank requires the borrower to make available some forms of collateral security which will be pledged whenever a customer makes a request for loan facility. In small loans to customers, the practice is for the customer to provide a guarantee to the bank. This involves providing some guarantors who are made to fill appropriate forms for their preparedness to guarantee the repayment of the funds granted for the loan facilities.

Therefore, guarantees can be given by individuals or associated companies to the firms taking the loan facilities. Such guarantors as pointed out earlier are individuals sign agreements with the banks with the understanding that they agree to honour any outstanding installments of the loans in the event of defaults. The extent of the guarantee undertaken by the guarantors can be limited to a fixed or variable amount and time.

More often than not, the security offered in a loan agreement is considered in relation to the creditworthiness of the borrower. Nevertheless, in the case of doubt due to the problem of integrity of the borrower, it may be necessary to demand for some guarantee for the loan facility from the customer. The guarantees made by individuals who stand as guarantors are not all that secured or enough due to issue of integrity.

SELF ASSESSMENT EXERCISE 3

Discuss the use of personal guarantee in place of security for loan facility from the bank.

4.0 SUMMARY

In pledging collateral security for a loan facility by loan beneficiary, the bank should be able to understand that there are basic types of property such as real estate, personal property, accounts receivable, factoring, and inventory. Banks can also accept personal guarantee in place of collateral security in relation to small loans to customers.

5.0 CONCLUSION

In this course of analysis in this study unit, we have discussed securities for ensuring recovering of loans advanced by banks to their customers and in the process we have analyzed; Securities and Loan Recovery; Property for Collateral Security; Valuables for Collateral Security; and Personal Guarantee in Place of Security. In the next study unit, we shall discuss securities for bankers' advances.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Mention and explain types of property that can be pledged as collateral security for a loan facility.

2. Mention and explain types of valuable that can be pledged as collateral security for a loan facility.

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UNIT 5: SECURITIES FOR BANKERS' ADVANCES

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we discussed some forms of advances that banks grant the corporate for enhancing their operations. Relatedly, therefore, we shall discuss the forms of securities that are acceptable to the banks towards securing their funds which their customers are given at the instance of granting of any facility.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- Explain bankers' lien
- Discuss pledge by loan beneficiary
- Discuss hypothecation as a form of security for a loan

3.0 MAIN CONTENT

3.1 Banker's Lien

Legally, a lien is a right to retain properties belonging to the debtor until he has discharged the debt due to the retainer of the properties. A banker's lien is a general lien, which confers a right to retain properties in respect of any general balance due by the debtor to the banker. Bankers have a general lien on all securities deposited with them in their capacity as bankers by a customer, unless there is an express contract or circumstances that show an implied contract inconsistent with the lien, as has been held in *Brandao vs Barnett.* In the case of lien, banker's right of sale extends only to fully negotiable securities. In this connection, in respect of such negotiable securities, the banker may exercise his right of sale after serving reasonable notice to the customer. In the case of

securities other than fully negotiable securities, the banker is well advised to realize them only after getting sanction from a competent court of law.

SELF ASSESSMENT EXERCISE 1

Explain the term banker's lien.

3.2 Pledge

A pledge, as a term in relation to collateral security, is a contract whereby an article is deposited with a bank (lender) as a promise or security for the repayment of a loan or performance of a promise by the beneficiary (borrower). In order to complete a contract of pledge, delivery of the goods to the banker is necessary. Delivery of the title documents relating to the goods, or the key of the warehouse where the goods are stored, may be sufficient to create a valid pledge. Basically, where no possession is given, it is known as 'hypothecation', which will be discussed subsequently in this study unit.

There are three essential features of a pledge such as: (i) there must be a bailment of goods, i.e. delivery of goods; (ii) the bailment must be by way of security; and (iii) the security must be for payment of a debt or performance of a promise. A pledge gives the pledgee no right of ownership.

1) Circumstances under which the law permits a pledge by a non-owner include the following:

a. A mercantile agent can create a valid pledge, provided he is in possession of the goods, with the consent of the owner. Further, a valid pledge may be created even when the mercantile agent is acting without the authority of the owner provided the pledge acts in good faith.

b. A seller, who is in possession of the goods after the sale may create a valid pledge, provided the pledgee acts in good faith and without notice of the sale.

c. A buyer, who is in possession of the goods or of the documents of title to the goods, before payment of the price, may create a valid pledge, provided the pledgee acts in good faith and without notice of the defective title of the pledger.

d. A pledger, who has only a limited interest in the goods which he pawns can create a valid pledge to the extent of such interest.

e. One of the joint owners in sole possession of the goods with the consent of the others may create a valid pledge.

f. A person who is in possession of the goods under a voidable contract (on the grounds of, say, fraud, misrepresentation, coercion, etc.) may create a valid pledge provided the contract is not rescinded at the time of the pledge. However, a thief cannot create a valid pledge of stolen goods.

The banker may redeliver, for a specific purpose, the goods pledged with him. A properly drafted 'Trust Letter', clearly indicating the limited purpose for which the goods are redelivered would be a precaution. Possession can also continue to be evidenced by the bank's own board being exhibited at the place of storage.

2) Right of realization of the securities pledged

A pledgee is entitles to the following rights in case of default in payment of the debt by the pledger:

a. He may file a suit for recovery of the amount due to him, while retaining the goods pledged.
b. He may file a suit for the sale of the goods pledged and the realization of the money due to him.
c. He may himself sell the goods pledged after giving reasonable notice to the pledger notwithstanding any contract to the contrary. In case the proceeds do not meet the debt fully, he may sue the pledger for the balance. If there is any surplus, it must be paid over to the pledger.

3) The banker as a pledgee entitled for any accretion to the goods pledged

In the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, or according to his directions, any increase or profit which may have accrued from the goods bailed.

4) Sale of security pledged without reasonable notice

Sale of securities pledged without reasonable notice is not binding on the pledger. In case where the pledgee sells the goods without giving due notice, he will become liable for conversion; but the sale is not avoided thereby and is not liable to be set aside. It is not compulsory on the part of the pldgee to sell the goods at any particular time or within a

reasonable time after the notice is served.

5) Redelivery of goods pledged

Where a pledgee files a suit for the recovery of the debt, he is entitled to retain the goods; but he is bound to return them on payment of the debt. The right to sue on the debt assumes that the pledgee is in the position to redeliver the goods on payment of the debt and therefore, if he has put himself in a position where he is not able to redeliver the goods, he cannot obtain a decree. But if he sues on the debt denying the pledge and it is found that he was given possession of the pledged goods and had retained the same, the pledger has the right to redeem the goods so pledged by payment of the debt. If the pledgee is not in position to redeliver the goods, he cannot have both the payment of the debt and also the goods.

6) Documents of title and pledge

Where a mercantile agent is without the consent of the owner, in possession of the goods or documents of title to goods, a pledge made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorized by the owner of the goods to make the same.

7. Status of Documents of title to goods in relation to pledge

Under Section 2(4) of the Sale of Goods Act, a 'document of title to goods' is defined as

Bill of lading, dock warrant, warehouse keeper's certificate, railway receipt, warrant or order for the delivery of goods, and any other document used in the ordinary course of business as proof of possession or control of goods or authorizing or purporting to authorize by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented.

Following are the norms for a transport company to obtain the approval of the Association:

i) The transport company should not deliver the goods except on the bank's discharge and instructions for delivery on the original receipt itself, which should be produced for delivery. A clause to this effect should appear in the transport company’s receipt.

ii) A transport company’s receipt intended for negotiation with a bank should not be drawn in the name of the consignee.

iii) For all damages suffered by a bank as a result of the negligence of the transport company, the company must be responsible.

SELF ASSESSMENT EXERCISE 2

Enumerate and explain the conditions surrounding the use of a pledge.

3.3 Hypothecation

A 'mortgage of movables' may be defined as a transfer, by way of security of the general ownership of the chattel, subject to the equity of redemption of the mortgagor. Mortgage of movables can be made by mere parole and without transfer of possession. However, a subsequent mortgagee with possession, in the absence of notice of the previous mortgage, will get priority over a prior mortgage without possession. In the strict sense the term 'mortgage' is used only in connection with immovables. In the case of movables, the terms 'pledge' and 'hypothecation ' are generally used. Where a mortgage of movables is created by delivery of possession of goods, it is known as a 'pledge', and where no possession is given it is known as 'hypothecation'.

In the case of hypothecation, a document known as "Letter of Hypothecation" is executed. This document details the terms under which the relevant goods are hypothecated. Briefly, the following are the main contents of the letter of hypothecation are as follows.

(a) Affirmation by the borrower that the goods are free from encumbrances, that further encumbrances will not be created on them and that he is the absolute owner of the goods

(b) Undertaking by the borrower that proceeds arising from the sale of the hypothecated goods will be utilized for the repayment of the advance.

(c) Undertaking by the borrower to meet all expenses relating to the safe custody of the hypothecated goods and that sufficient margin acceptable to the banker will be maintained at all times.

(d) Provision to the effect that the banker has the right to take possession of the hypothecated goods and to realize them in the event of the borrower making default in the repayment of the advance.

SELF ASSESSMENT EXERCISE 3

Mention and explain various types of securities.

4.0 SUMMARY

From our discussion in this unit, we have identified and explained securities that can be accepted by the banks for their customers for advances. Such securities, as we have discussed, include lien, pledge, mortgage and hypothecation.

5.0 CONCLUSION

In this course of analysis in this study unit, we have discussed securities for bankers' advances and in the process, espoused on: Banker's Lien; Pledge; and Hypothecation. In the next study unit, we shall discuss negotiable instruments: cheques, promissory notes and bills of exchange.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between pledge and lien.
2. Enumerate and discuss various securities that can be accepted by the banks for advances.

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UNIT 6 LAND AND SECURITY

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we have discussed the issue of securities and loan recovery. There are instances under which bank advances are given based on the use of land buildings as collateral securities, which are made available by the customers as loan beneficiaries. The use of land and buildings involves pledging some property of the business as securities while they are regarded as immoveable property. They are stationery at the particular places where they are located. Hence the issue of using land and buildings as collateral securities by the beneficiaries, which the bankers accept for advancing the loanable funds, constitute the subject of discussion in this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- mention precautions towards accepting land and buildings as securities by banks
- list and discuss terms associated with mortgages
- mention and explain various kinds of mortgages
- explain the use of debenture.

3.0 MAIN CONTENT

3.1 Nature and Precautions for Taking Land and Building as Securities

When advancing money on the basis of land and building, the banker is inadvertently advancing money on the mortgage of the property so

pledged for the loan. Before, delving into the discussion on mortgage in relation to land and building as securities, it is pertinent to point out the following precautions, which must be observed by the bankers.

1. The banker has to comply with the detailed requirements specified in the extant laws and regulations.

2. The mortgage deed should be meticulously drafted in order to cover all contingencies that are likely to arise from the agreement.

3. In some cases, the banker may find himself in a precarious situation if the title deeds deposited turn out to be defective.

4. Therefore, in such a situation, the deeds can be reclaimed by the true owner without repayment of the amount advanced, even though the banker has acted in good faith and without actual or constructive notice of the defective title.

5. Basically, in some instances, the person holding the title deeds may only be a mortgagee, in which case he only has the right to transfer his interest in the property.

6. Realisation of the mortgaged property in case of default by the borrower is possible only after complying with all the legal requirements, which may involve some costs and time.

7. Difficulties in valuation of mortgaged property and the interpretation of the provisions of land tenures (traditional and government) can further pose some problems for the bankers.

8. In such situations, the banker will have to depend on expert advice from legal luminaries and estate valuers, which in any case will involve time and costs.

9. The issue of second mortgages is considered still less satisfactory as banking securities. The rights of the second mortgagee are subject to and subordinate to those of the first mortgagee.

10. Regardless of the possibility of a considerable margin between the mortgage and the mortgageable value, the banker's position is still not secure.

11. The first mortgagee may add any arrears of interest to the debt in priority of the second mortgagee.

12. Furthermore, under certain circumstances, the first mortgagee may make further advances, which will get priority over the second mortgagee.

13. Hence, such can only be guarded against by ascertaining the extent of interest of the first mortgagee by the bankers, and whether they are under any obligation to make further advances.

SELF-ASSESSMENT EXERCISE 2

Mention the precautions that should be taken by bankers when accepting land and buildings as securities.

3.2 Terms Associated With Mortgages

1. Immovable Property

When the banker is securing advances with collaterals, the relevant issue is whether a particular collateral is a movable or an immovable property as in the case of land and building. It is instructive to note that may be recalled here that a mortgage can be created only by a transfer of interest in an immovable property. Basically, this point is relevant for determining the period of limitation for a suit for declaration of the title to the property, or for recovery of possession of the property.

2. Mortgagor and Mortgagee

Basically, the person who transfers an interest in a specific immovable property is known as the mortgagor and the person to whom the interest is transferred is called the mortgagee.

3. Creation of a Mortgage

Fundamentally, a mortgage may be created either by deposit of title deeds, by delivery of possession, or by a registered document.

Creating mortgage on an immovable property does not need any particular form. In broad based terms, for creating a charge on immovable property no particular form of words is needed; adequate words of intention may be expressed to make property or fund belonging to a person charged for payment of a debt mentioned in the deed. However, in order that a charge may be created, there must be evidence of intention disclosed by the deed that a specified property or fund belonging to a person was intended to be made liable to satisfy the debt due by him.

SELF-ASSESSMENT EXERCISE 2

Differentiate between mortgagor and mortgagee.

3.3 Classification of Mortgages

There are various types of mortgage as identified and explained as follows:

1. Simple Mortgage

Where, without delivering possession of the mortgaged property, the mortgagor binds personally to pay the mortgage money and agrees, expressly or impliedly that, in the event of his failing to pay according to the contract, the mortgagee shall have be right to cause the mortgaged property to be sold and the proceeds of sale to be applied, so far as may be necessary, in payment of the mortgage money, the transaction is called a simple mortgage, and the mortgagee a simple mortgagee.

2. Mortgage by Conditional Sale

A mortgage by conditional sale is different from a sale with a condition to repurchase. In the former case, the transfer is made to constitute a security for a debt. Relatedly, the right of taking back the property on payment of the amount due is not lost even though the mortgagor fails to pay on the appointed day. In the case of a sale with a condition to repurchase, there is no debt for which the transfer is a security. Moreover, there is a transfer of all the rights in the property reserving only a personal right of repurchase, which is lost if not exercised within the agreed time.

A mortgagee, in the case of a mortgage by conditional sale, has the right to sue for foreclosure on default of the mortgagor to repay the amount. A suit to obtain a decree that a mortgagor shall be absolutely debarred of his right to redeem the mortgaged property is called a 'suit for foreclosure'.

3. Usufructuary Mortgage

Where the mortgagor delivers possession expressly or by implication binds myself to deliver possession of mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage money, and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage money or partly in lieu of interest and partly in payment of the mortgage money,

the transaction is called a usufructuary mortgage, and the mortgagee a usufructuary mortgagee.

Hence, in the case of a usufructuary mortgage, the mortgagor delivers possession of the mortgaged property. He is entitled to recover possession of the mortgaged property when he pays back the debt or when the debt is discharged by rents and profits received.

4. Mortgage by deposit of title deeds

This type of a mortgage is called an *Equitable Mortgage*. There is no registration that is required in the case of a 'mortgage by deposit of title deeds. It is effected merely by deposit of title deeds.

In terms of rights of a mortgagee by deposit of title deeds, all provisions relating to a simple mortgage are applicable to a mortgage by deposit of title deeds. Hence there is a personal liability on the mortgagor to pay the debt. In addition, the mortgagee is allowed to realize the debt by selling the property with the sanction of the Court.

5. Anomalous mortgage

An 'anomalous mortgage' may arise by a combination of two or more kinds of mortgages enumerated below, or by usage in particular localities. An example of such a mortgage may be found in a combination of a simple mortgage and a usufructuary mortgage. Here, in addition to the mortgagee's right to appropriate rents and profits against the amount due, he also has the right to personally realize the debt from the mortgagor.

SELF-ASSESSMENT EXERCISE 3

Mention and explain various types of mortgage.

4.0 CONCLUSION

From our discussion in this unit, we have stated that mortgage refers to pledging some specific property for taking loanable funds by the customers of banks. There are peculiar terms that are associated with mortagage such as mortgagor and mortagee, movable and immoveable property, among others. There are also various types of mortgage such as simple mortgage, mortgage by conditional sale, usufructuary mortgage, mortgage by deposit of title deeds, and anomalous mortgage.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed: meaning of mortgage; terms associated with mortgages; classification of mortgages; and debenture. these issues in respect of mortgage will still be discussed in a subsequent study unit. In the next study unit however, we shall discuss negotiable instruments: cheques, promissory notes and bills of exchange.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between mortgage and debenture.
2. Mention the precautions to be taken by banks while accepting mortgage as securities for loan.

7.0 REFERENCES/FURTHER READING

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MODULE 3

UNIT 1 SHARES AS COLLATERAL SECURITIES FOR BANK ADVANCES

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we have discussed the issue of land and buildings as securities for bank advances which borders on mortgage. There are instances under which bank advances are given based on the use of capital market securities such as shares as collateral securities, which are made available by the customers as loan beneficiaries. The use of shares involves pledging some investments which are in the capital stock that are tradable in the capital market. Hence the issue of shares as collateral securities by the beneficiaries, which the bankers accept for advancing the loanable funds, constitutes the subject of discussion in this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss stock exchange securities
- list and discuss terms associated with stock exchange securities
- differentiate between negotiable and non-negotiable securities.

3.0 MAIN CONTENT

3.1 Stock Exchange Securities

The stock exchange securities include all financial instruments issued by private enterprises, public enterprises and governments at federal, state and local levels. Fundamentally, bankers generally consider stock exchange securities as acceptable securities for advancing funds to the customers. In the event of necessity, such securities can be traded in the stock exchange and their funds realized without much difficulty. In essence, it is comparatively easy to ascertain the value of most stock exchange securities. It is also easy to determine their title, and above all, some of these securities are fully negotiable.

3.1.1 Valuation of Stock Exchange Securities

The value of stock exchange securities depends on the category to which they belong. Basically, the securities issued by industrial and commercial enterprises rank next to the securities issued by Government and public enterprises. The valuation of securities issued by industrial and commercial enterprises depends on a number of factors; these include: the nature of the security, the stability of the organization that has issued it, the ease with which such can be realised without loss being incurred besides the costs for their transactions.

In respect of ascertaining the value of the shares of industrial enterprises, there are many factors that are to be taken into consideration. The quotations on shares on stock exchange are often considered as a safe guide in assessing the value of such securities. However, it is advisable to supplement stock exchange quotations with an independent valuation. The past record on the performance of the enterprises concerned in respect of quoted shares should be taken into careful consideration. Hence, the banker should ascertain the dividend records and the balance sheet of the organizations for the past five years, at least.

In the above respect, shares with steady dividend records are more acceptable as collateral securities for bank advances. Furthermore, the

integrity and business acumen of the promoters, the management team and directors of the enterprise are also of considerable importance in assessing the acceptability of the company's shares. Furthermore, the future prospects of the company in particular and its industry should also be carefully evaluated. In case of a depression being imminent in such an industry, the shares of its firms cannot be acceptable as securities for bank advance.

The preference shares, where they are used as collateral securities for advances, are more acceptable as compared to ordinary shares. Nevertheless, preference shares do not carry a preferential right as to the repayment of capital in relation to the right of the creditors. This implies that preferential shareholders' right as to the repayment of capital is subject to the discharge of all debts owed by the company and payment of charges ranking prior to the preference shares. A company which has issued a large number of preference shares may, for all practical purposes, be considered to have all the risks associated with ordinary shares.

In the course of valuing ordinary shares, the banker should take into consideration the aggregate value of such shares which come before them in ranking for dividend and/or return of capital. For example, the ordinary stock of a company which has issued no other class of shares would, other things being equal, be better as banking security than ordinary shares of a company which has issued numerous preference shares of large aggregate value.

It is also imperative to ascertain whether or not the shares under consideration are fully paid up. In the event that they are partly paid-up shares, due contemplation should be accorded the amount remaining unpaid. In addition, the banker should ensure make certain that no call has been made which the holder of the shares has failed to pay.

SELF-ASSESSMENT EXERCISE 1

Discuss the valuation of stock exchange securities.

3.1.2 Margin for Stock Exchange Securities

The market price of a stock exchange security is prone to fluctuations. Therefore, the banker should insist on adequate margin in order to cover any possible price fluctuations, which depends on the class of security. This implies that margin which bankers will insist on varies according to the type of securities.

The prices of government securities do not vary widely because such securities are gilt-edged securities. Nevertheless, changes in the interest rates have a considerable bearing on their prices. In the event that the interest rate increases, the value of such securities tends to decrease. Similarly, the state of trading in the capital market influences the prices of government securities. During a period of active trade, their prices tend to increase. Thus, the future course of interest rates and state of trading on government securities should be carefully studied bankers while fixing the margin for government securities.

The same considerations apply in the case of state and local government securities. In respective of debentures of industrial enterprises, this margin depends on the standing and financial position of the company issuing them. Nevertheless, the margin for them will generally be higher as compared to that of Government securities.

The margin required by bankers for shares of industrial enterprises will be higher than that for government securities or industrial debentures. Such margin will still be higher in the case of ordinary shares compared to preference shares. In any case, the margin varies according to the creditworthiness of the issuing company, its past performance, dividend records and the future of the particular industry in which the firm is operating. The stock exchange quotations of such securities are also taken into consideration. In the case of partially paid shares, the margin is based on the amount paid up on them. In this connection, it should be noted that the failure to pay for share on calls whenever they are made may make the shares liable for forfeiture.

3.1.3 Liquidity of Stock Exchange Securities

The banks should always be careful in selecting shares as securities; they should only insist on liquid securities as cover for their advances. Basically, liquidity implies the ability of the securities to be converted into cash on demand. In other words, liquidity refers to the easy with which the securities can be traded for cash in the capital market without loss. For example, the ordinary shares of an industrial enterprise may be easily traded, but only at a discount. Here, liquidity is possible only at a loss and hence cannot be considered as a sound banking security. Bankers should always bear in mind that liquidity should not be sacrificed for profitability.

3.1.4 Necessity of Written Agreements (Memorandum of Deposit) on Charging Stock Exchange Securities

In legal terms, a written agreement is not necessary in the case of a pledge or a mortgage of movable properties. Nevertheless, bankers are

advised to take written agreements while advancing money on stock exchange securities. Basically, the mere deposit of securities with the intention to create a charge thereon will give the banker a charge over the securities. However, a written agreement, which is regarded as 'Memorandum of Deposit' can include certain provisions that are favourable to the banks.

In respect of the 'Memorandum of Deposit' for shares, there are basic provisions that pertinent and must be incorporated in it. Such provisions include the following:

1. Statement specifying that the securities are deposited with the intention of creating a charge for the purpose of securing any sum due to the banks.

2. There must be an undertaking by the depositor to maintain a specified margin.

3. There must be an agreement that the amount due shall be repaid on demand.

4. There should be an authority to the bank to realize the securities without obtaining the previous consent of the depositor.

5. There should be a provision that the security shall be a continuing one.

6. There should be a promise by the depositor to pay any unpaid installments or calls that may become due on the shares.

7. There should be an agreement that the charge shall cover amounts due from a survivor, in the case of joint accounts.

8. In the case that the securities are deposited on behalf of a partnership firm, there should a provision that the banker's position will not be affected by any change in the constitution of a partnership firm arising out of the death, insolvency, insanity, retirement or admission of a partner.

9. In the event that the securities are deposited on behalf of a limited company, there should be a stipulation that the banker's rights shall not be affected by any change in the constitution of the company by reason of amalgamation or absorption.

10. There should be a declaration by the depositor that he has a good title to the securities deposited.

11. There should be a schedule as annexure to the memorandum of deposit showing the details of the securities deposited.

SELF-ASSESSMENT EXERCISE 2

Mention the essentials provisions in respect of Memorandum of Deposit for shares when being used as securities for bank advances.

4.0 CONCLUSION

From our discussion in this unit, we have stated that capital market securities such as shares can be taken by the banks for advancing funds to their customers. However, there are certain precautions that should be observe by the banks before the acceptance of shares. In accepting shares as securities, there is the necessity for a written agreement in form of Memorandum of Deposit. Furthermore, there certain classes of securities that cannot be accepted as securities for bank advances; these include shares in private companies, unquoted shares and shares in foreign companies.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed stock market securities in relation to bank advances, and in the process, we espoused on: stock exchange securities; valuation of stock exchange securities; margin for stock exchange securities; liquidity of stock exchange securities; and necessity of written agreements (memorandum of deposit) on charging stock exchange securities. In the next study unit, we shall discuss negotiable securities and non-negotiable securities.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Differentiate between Negotiable and Non-Negotiable Securities.
2. Give reasons why some classes of shares cannot be accepted as securities for bank advances.

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UNIT 2: NEGOTIABLE AND NON-NEGOTIABLE SECURITIES

CONTENTS

1.0 INTRODUCTION

Some of the securities that are accepted by the banks are negotiable while some others are not negotiable. There are instances under which bank advances are given based on negotiable instruments such as capital market securities, as made available by the customers as loan beneficiaries. The use of non-negotiable securities by loan beneficiaries should be accepted with caution so that banks do not lose their funds in the process. Hence the issue of negotiable securities and non-negotiable securities as collaterals, which the bankers accept for advancing the loanable funds, constitutes the subject of discussion in this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss negotiable securities for bank advances
- explain non-negotiable securities for bank advances.

3.0 MAIN CONTENT

3.1 Negotiable Securities

Some of the stock exchange securities are fully negotiable. Accordingly the Negotiable Instruments Act explains that a negotiable instrument means a promissory note, bill of exchange or cheque payable, either to order or bearer. Besides these ones, there are other instruments considered as negotiable instruments which the mercantile custom judicially recognized. Basically, the transfer of a negotiable instrument is effected by delivery or by endorsement and delivery, and the property in a negotiable instrument is acquired by every person who takes it bona

fide and for value, notwithstanding any defect in the title of the person from whom he took it.

Securities like bonds payable to bearer, share warrants, and debentures payable to bearer, among others, are treated as negotiable securities. In the case of debentures payable to bearer, the custom to treat them as negotiable by delivery is recognized by the appropriate law.

The negotiable securities are considered ideal as banking securities. The mere deposit of such securities with intent to pledge gives the banker complete title to them, with a right of sale implied in a pledge. Nevertheless, bankers generally take a `Memorandum of Deposit' as discussed above which is indicative of the purpose of the deposit, and containing a clause that the security shall be a continuing one.

Furthermore, the banker is often given an express power of sale. Essentially, therefore, when banks are advancing money on securities which are negotiable instruments but which are to be transferred by endorsement and delivery, they should see that they are properly endorsed in favour of the banks.

SELF-ASSESSMENT EXERCISE 1

Discuss negotiable securities for bank advances.

3.2 Non-Negotiable Securities

Banks do not get a legal title by mere deposit of non-negotiable securities such as registered shares, registered stocks, inscribed stocks, etc. Banks can only perfect their security by having it transferred into their own names. A bank advancing money on the deposit of share certificates gets only an equitable title.

1. Equitable mortgage

In the case of non-negotiable securities, an equitable mortgage is effected by:

(a) Deposit of the securities with the intention to create a charge;
(b) Deposit of the securities with a Memorandum of Deposit;
(c) Deposit of the securities with a Memorandum of Deposit and duly executed blank transfers.

In respect of banker's position, an equitable mortgage is not desirable due to some defects showing the unsatisfactory nature of an equitable mortgage. Such defects include the following:

i) A prior equitable mortgage, effected with or without the banker's knowledge, will rank before his equitable charge;
ii) The mortgagee may be holding the securities as a trustee, in which case the beneficiaries of the trust will get a prior equitable title;
iii) An equitable title will be postponed to a subsequent legal title;
iv) The mortgagor may have only an equitable title to the securities, which means he cannot pass more than his own equitable title to the banker; and
v) The company issuing the securities may have a lien over them as against the registered owner.

Due to the above defects, the banker should not advance money on an equitable mortgage except on exceptional cases. Furthermore, the bank should try to protect its interests by giving the issuing company a notice of lien in duplicate, with a request that the company acknowledges the notice by endorsing and returning the duplicate. Nevertheless, such a notice does not obtain for him a priority over a prior equitable title. But, it still secures priority for the banker over any future advances made by the company to the shareholder. It also minimizes the possibility of a mortgagor fraudulently obtaining duplicate copies of his share certificates and passing a legal title to some other person.

SELF-ASSESSMENT EXERCISE 2

Identify the defects inherent in the unsatisfactory nature of an equitable mortgage.

4.0 CONCLUSION

From our discussion in this unit, we have stated that we have stated that some of the collaterals being offered by bank customers for advances are negotiable while some others are not negotiable. The bank should accept such non-negotiable instruments with caution so that in the final analysis, funds advanced out can be recouped without problems, which can affect the operations of the benefactors.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed negotiable securities and non-negotiable securities in relation to the advances being made by the banks to the customers. In the next study unit, we shall discuss mortgages and debentures.

6.0 TUTOR-MARKED ASSIGNEMENT

Differentiate between Negotiable and Non-Negotiable Securities.

7.0 REFERENCES/FURTHER READING

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UNIT 3: MORTGAGES AND DEBENTURES

CONTENTS

1.0 INTRODUCTION

There are instances under which bank advances are given based on the use of mortgages and debentures as collateral securities, which are made available by the customers as loan beneficiaries. The former involves pledging some property of the business as securities while the latter involves the use of investment in debentures as collateral for securing the funds involved in the loan facilities. Hence the issues of mortgages and debentures as securities for advances constitute the subject of discussion in this study unit of the material.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of mortgage
- mention and discuss terms associated with mortgages
- mention and explain various kinds of mortgages
- explain the use of debenture.

3.0 MAIN CONTENT

3.1 Mortgage

The term mortgage is regarded as the transfer of an interest in a specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to pecuniary liability.
Hence, the inherent fundamentals in the above definition of mortgage in

relation to collateral in lending include:

a. There must be a transfer of interest in an immovable property.
b. The immovable property must be a specific one.
c. The consideration of a mortgage may be either money advanced or to be advanced by way of a loan, or the performance of a contract.

SELF-ASSESSMENT EXERCISE 1

Define the term Mortgage in relation to bank facility to a business entity.

3.1.1 Terms Associated with Mortgages

1. Immovable Property

When the banker is securing advances with collaterals, the relevant issue is whether a particular collateral is a movable or an immovable property. It is instructive to note that a mortgage can be created only by a transfer of interest in an immovable property. Basically, this point is relevant for determining the period of limitation for a suit for declaration of the title to the property, or for recovery of possession of the property.

2. Mortgagor and Mortgagee

Basically, the person who transfers an interest in a specific immovable property is known as the mortgagor and the person to whom the interest is transferred is called the mortgagee.

3. Creation of a Mortgage

Fundamentally, a mortgage may be created either by deposit of title deeds, by delivery of possession, or by a registered document.

Creating mortgage on an immovable property does not need any particular form. In broad based terms, for creating a charge on immovable property no particular form of words is needed; adequate words of intention may be expressed to make property or fund belonging to a person charged for payment of a debt mentioned in the deed. However, in order that a charge may be created, there must be evidence of intention disclosed by the deed that a specified property or fund belonging to a person was intended to be made liable to satisfy the debt due by him.

SELF-ASSESSMENT EXERCISE 2

Differentiate between mortgagor and mortgagee.

3.3.2 Classification of Mortgages

There are various types of mortgage as identified and explained as follows:

1. Simple Mortgage

Where, without *delivering* Possession of the mortgaged property, the mortgagor binds personally to pay the mortgage money and agrees, expressly or impliedly that, in the event of his failing to pay according to the contract, the mortgagee shall have be right to cause the mortgaged property to be sold and the proceeds of sale to be applied, so far as may be necessary, in payment of the mortgage money, the Act transaction is called a simple mortgage, and the mortgagee a simple mortgagee.

2. Mortgage by Conditional Sale

A mortgage by conditional sale is different from a sale with a condition to repurchase. In the former case, the transfer is made to constitute a security for a debt. Relatedly, the right of taking back the property on payment of the amount due is not lost even though the mortgagor fails to pay on the appointed day. In the case of a sale with a condition to repurchase, there is no debt for which the transfer is a security. Moreover, there is a transfer of all the rights in the property reserving only a personal right of repurchase, which is lost if not exercised within the agreed time.

A mortgagee, in the case of a mortgage by conditional sale, has the right to sue for foreclosure on default of the mortgagor to repay the amount. A suit to obtain a decree that a mortgagor shall be absolutely debarred of his right to redeem the mortgaged property is called a 'suit for foreclosure'.

3. Usufructuary Mortgage

Where the mortgagor delivers possession expressly or by implication binds myself to deliver possession of mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage money, and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage money or partly in lieu of interest and partly in payment of the mortgage money,

the transaction is called a usufructuary mortgage, and the mortgagee a usufructuary mortgagee.

Hence, in the case of a usufructuary mortgage, the mortgagor delivers possession of the mortgaged property. He is entitled to recover possession of the mortgaged property when he pays back the debt or when the debt is discharged by rents and profits received.

4. Mortgage by deposit of title deeds

This type of a mortgage is called an 'Equitable Mortgage'. There is no registration that is required in the case of a 'mortgage by deposit of title deeds. It is effected merely by deposit of title deeds.

In terms of rights of a mortgagee by deposit of title deeds, all provisions relating to a simple mortgage are applicable to a mortgage by deposit of title deeds. Hence there is a personal liability on the mortgagor to pay the debt. In addition, the mortgagee is allowed to realize the debt by selling the property with the sanction of the Court.

5. Anomalous mortgage

An 'anomalous mortgage' may arise by a combination of two or more kinds of mortgages enumerated below, or by usage in particular localities. An example of such a mortgage may be found in a combination of a simple mortgage and a usufructuary mortgage. Here, in addition to the mortgagee's right to appropriate rents and profits against the amount due, he also has the right to personally realize the debt from the mortgagor.

SELF-ASSESSMENT EXERCISE 3

Mention and explain various types of mortgage.

3. Debentures

The value of the debentures issued by corporate bodies or enterprises depends on their creditworthiness. It is instructive to note that high interest rates do not, as a rule, indicate their worth but it is also the prevailing market values that are more important. Nevertheless, some high yield of debentures may be an indication of their non-suitability as banking securities.

Prior to accepting debentures, issued by a company, as collateral securities for advancing money, it is necessary for the bank to take the following steps to ensure the protection of its own interest:

1) The bank should ascertain from the company's Memorandum and Articles of Association whether they are issued in accordance with its power;
2) He should also ascertain whether the company has issued any debentures before the present issue;
3) In case a specific prior charge over the property charged to the banker has been registered, his security will be postponed to that of the earlier charge;
4) The banker should see that the debentures provide that the company shall not create any further charge to rank before or *pari passu* with the banker's charge; and
5) When a debenture gives a specific charge over certain assets, it should be accompanied by deeds or other documents evidencing the title of the company to the property.

4.0 CONCLUSION

From our discussion in this unit, we have stated that mortgage involves pledging some specific property for taking loanable funds by the customers of a bank. There are peculiar terms that are associated with mortagage such as mortgagor and mortagee, movable and immoveable property, among others. There are also various types of mortgage such as simple mortgage, mortgage by conditional sale, usufructuary mortgage, mortgage by deposit of title deeds, and anomalous mortgage.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed: meaning of mortgage; terms associated with mortgages; classification of mortgages; and debenture. In the next study unit, we shall discuss produce and goods as securities for bank advances.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between Mortgage and Debenture.
2. Mention the precautions to be taken by banks while accepting mortgage as securities for loan.

7.0 REFERENCES/FURTHER READING

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UNIT 4 PRODUCE AND GOODS AS SECURITIES

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we have discussed the issue of debentures in relation to its use as securities for bank advances. There are instances under which produce and goods can be accepted by banks as securities for their advances. Hence the issue of produce and good being used as securities for advances is discussed in this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the rational for taking produce and goods as securities for advances
- list and explain documents of title to goods
- differentiate between right of lien and right of stoppage in transit
- mention and explain types of documents associate with produce and goods.

3.0 MAIN CONTENT

3.1 Rationale for Taking Produce and Goods as Securities

The use of produce and goods as securities arises when a wholesaler is taking an advance for the purpose of purchasing goods. And the source of repayment is the sale proceeds of the goods purchased. Therefore, the banker has the sale of the goods as the source for repayment.

There are some fundamental reasons which inform the acceptance of produce and goods by banks as securities for their advances to their customers. Such reasons are identified below.

i) Produce and goods as securities offer something tangible for the banker to realize in case of the customer's default.
ii) Produce and goods are easily realizable as compared to immovable properties.
iii) Produce and goods are comparatively easier to evaluate.
iv) The source for repayment of advances, based on the produce and goods, is comparatively secure.

On the contrary, the use of produce and goods as securities can be fraught with problems. Basically, there are certain disadvantages to this form of security. Such disadvantages are as identified below.

i) Possibilities of deterioration of the goods,
ii) Perpetration of fraud as regards their quality, value and title, and risk of heavy fluctuations in their value, especially when they are not necessities of life.

Hence it has been argued that successful loaning against such security calls for specialized knowledge on the part of the bankers. The responsibilities of the bankers, therefore, are in the following areas:

1) The first important point is to ascertain the quality of the goods.
2) This kind of security should be accepted only from persons of business integrity.
3) The banker should try to make an independent examination of the risk of deterioration is also an equally important point.
4) The nature of the goods should be carefully studied. If the goods are perishable in nature or are liable to fashion changes, they cannot be considered as an acceptable banking security.
5) The banker should try to limit his advances to non-perishable goods in everyday use, capable of ready sale.
6) The banker should be able to make as independent valuation of the goods. Here too, in certain cases, the banker will find the services of an expert valuer necessary.
7) He must be able to study the market conditions carefully. The importance of a careful study of the market conditions is pertinent, particularly when there are chances of higher market prices owing to the speculative hoarding of commodities. Revaluation at short intervals is also necessary.
8) The banker should see that the goods offered as security are properly insured and stored.
9) The banker has to be careful in cases where the seller reserves his rights over the goods sold by inserting a suitable clause in the contract of sale. In some trades, such clauses have been common for some time and the practice is used frequently in Europe. (*Borden (U.K.) Ltd. Vs Scottish Timber Products Ltd (1979).*

10) The banker should satisfy himself about the title of the goods pledged. Pledgee of goods does not get a better title than the seller had unless the owner of the goods, by his conduct is precluded from denying the seller's authority to sell or pledge.

Basically, certain exceptions to this general rule are laid down in the Sale of Goods Act. The law recognizes a pledge by a person who is not the owner but is in possession of the goods under the following circumstances:

1. In the case of a mercantile agent
2. In the case of one of the joint owners
3. In the case of a person in possession of the goods under a voidable contract
4. In the case of a buyer who is in possession of the goods before the payment of purchase price
5. In the case of a seller who is in possession of the goods after sale
6. In the case of a person having a limited interest in the goods

SELF-ASSESSMENT EXERCISE 1

What are the responsibilities of bankers in acceptance of produce and goods as securities for advances?

3.2 Documents of Title to Goods

Under Section 2(4) of the Sale of Goods Act, 'document of title to goods' is defined as:

Documents of title to goods include a bill of lading, dock warrant, warehouse-keeper's certificate, wharfinger's certificate, railway receipt, warrant or order for the delivery of goods and any other document used in the ordinary course of business as proof of the possession or control of goods, authorizing or purporting to authorize, either by endorsement or by delivery, the possession of the documents to transfer or receive goods thereby represented.

While lending money on the security of documents of title to goods, the banker has to carefully consider a number of factors, for instance:

i) The banker should remember that documents of title to goods do not guarantee the quality or the value of the goods specified therein.

For instance, in the case of a 'bill of lading' a clause is generally included to the effect that 'weight and contents unknown'. Here, the

banker has to depend on the integrity of the person shipping the goods.

ii) Secondly, unlike negotiable securities, title to the goods cannot be acquired through a person who has stolen the document or who has otherwise obtained the document without the seller's assent.

iii) The banker should be careful to distinguish 'documents that give title to goods' and 'documents that are mere receipts'. Bill of lading, dock and warehouse-keeper's warrants may be included under the former while warehouse-keeper's certificates, delivery orders may be included under the latter.

The above distinction is important because in the event of bankruptcy, the bona fide possession of a bill of lading or a warehouse-keeper's warrant by a banker is sufficient to take the goods out of the order and disposition of the bankrupt. Unless the goods have been registered in his name, possession of a delivery order or a warehouse-keeper's certificate is of no avail against the claim of the trustee in bankruptcy to possession of the goods.

iv) The banker should take sufficient precautionary measures to minimize the risks as identified above. He should see that the goods covered by the document of title are properly insured. He should also insist on a certificate from a reliable packer in order to ascertain the contents of the packages.

v) In addition, a 'letter of hypothecation' should be taken from the borrower lodging the documents as security. In fixing the margin, consideration should be given for accruing charges for storage and insurance. Above all, the integrity and honesty of the borrower should be taken into consideration.

SELF-ASSESSMENT EXERCISE 2

What are the factors to be taken into consideration by the banker while lending money on the security of documents of title to goods?

3.3 Right of Lien and Right of Stoppage in Transit

According to the Sale of Goods Act, an unpaid seller of goods, who is in possession of them, is entitled to retain possession until payment. However, he loses his lien when he delivers the goods to a carrier, or other bailee, for the purpose of transmission to the buyer, without reserving the right of disposal.

Under this consideration, the right of lien is, no doubt, lost, but the right of 'stoppage in transit' will be available. According to this right, an unpaid seller can prevent the goods from being delivered to the buyer. This right has been defined as a right possessed by the seller to resume the possession of goods not paid for, while on the way to the vendee. This right can only be exercised subject to the provisions of the Sale of Goods Act, and is lost if the buyer obtains delivery of the document of title and assigns the same to a bona fide purchaser for value. In reference to Section 53 of the Sale of Goods Act, it states the following.

1. Subject to the provisions of this Act, the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer may have made, unless the seller has assented thereto.

2. Provided that where a document of title to goods has been issued or lawfully transferred to any person as buyer or owner of the goods, and that person transfers the document to a person who takes the instrument in good faith and for consideration, then, if such last mentioned transfer was by way of a sale, the unpaid seller's right of lien or stoppage in transit is defeated.

3. If such last mentioned transfer was by way of pledge or other disposition for value, the unpaid seller's right of lien or stoppage in transit can be exercised subject to the right of the transferee.

4. Where the transfer is by way of a pledge, the unpaid seller may require the pledgee to have the amount secured by the pledge satisfied in the first instance, as far as possible, out of any other goods or securities of the buyer in the hands of the pledgee and available against the buyer.

Hence, it implies that where the pledgee has two or more securities, an unpaid seller can compel the pledgee to resort to the other security or securities first.

3.4 Types of Documents Associated with Produce and Goods

1. Bill of Lading

Bill of lading is a document issued by the ship owner, or by the Master or other agent on his behalf, which states that certain goods have been shipped on a particular ship and sets out the terms on which such goods have been delivered to, and received by the ship (*Sewell Vs Burdick).*

The bill of lading generally contains a provision to the effect of 'weight and contents unknown'. Therefore, the banker cannot ascertain the weight and contents of the packages from a bill of lading. Nevertheless, the banker may protect himself by insisting on the deposit of the relevant invoice showing the description and value of the goods along with the bill of lading.

The relevant certificate from a reputed packer can also be insisted on. The banker should ascertain whether the goods/packages were shipped in good order and condition. In which case, a 'clean bill of lading' is issued. Another point to be considered is whether or not the goods are covered by appropriate insurance. The banker should make sure that the insurance policy is attached with the bill of lading. The description of the goods in the insurance policy should correspond with that in the bill of lading.

A bill of lading is usually issued in triplicate, and signed by the Master on behalf of the ship owner. The Master of the ship is allowed to make delivery of the goods to the person who first presents one of the parts of the bill of lading, provided such delivery is made in good faith and without notice of any prior claim to the goods. As a rule, a condition is included in the bill of lading to the effect that when one of the three bills is accomplished, the other two are void. To be on the safe side, the banker should get all the parts of the bill of lading into his own hands. Where this is not possible, he should give notice of his claim to the ship owner as soon as possible, or if the goods have already been handed over to the dock company or warehouse keeper.

It is advisable to get the bill of lading endorsed in blank. A 'letter of hypothecation' should also be taken. This will protect the banker from any liability for freight and other charges on the goods. Of course, the banker is entitled to get delivery of the goods only after paying freight and other charges.

Sometimes a 'through bill of lading' is issued for the carriage of the goods partly in the ship of the ship owner and partly by land or in the ship of another ship owner for an inclusive freight. Such bills should be accepted by the banker only from reputable customers. Bills of lading which cover only a part of the journey should never be accepted as banking security.

The banker is well advised not to accept 'received for shipment bills of lading' as security. Such bills afford evidence of neither the goods being shipped, nor the vessel on which they were loaded. The usual bill of lading is a 'shipped bill of lading' which acknowledges receipt of goods on board a particular vessel.

When the goods arrive at the destination, the optimal course for the banker would be to hand over the bill of lading to a warehouse-keeper, with instruction to collect the goods and warehouse them in the name of the banker.

2. Dock and Warehouse Warrants

The 'dock warrant' is a document issued by a dock company stating that the goods described therein are deliverable to the person named in the warrant, or to his assignee by endorsement. A warehouse warrant is a document issued by a warehouse-keeper containing the same statement. When such warrants are accepted as security, the banker should make it a point of duty to register himself as the owner of the goods, or should lodge a 'stop order' with the dock company or warehouse keeper to prevent unauthorized dealing of the goods. The banker should also take the general precautions as incorporated in the discussion of ‘Documents of Title to Goods’.

3. Warehouse-keeper's Certificates

These certificates are mere acknowledgments by warehouse-keepers. Where the banker advances money on such certificates, he should see that a delivery order is made out in his favour. For failure to take such action, he will be unable to obtain possession of the goods and have them stored in his own name. A warehouse-keeper's certificate is only a deposit receipt and hence, generally not transferable by law. And when it is not transferable by law or through legislation, the safe course for the banker would be to get a certificate made out in the name of the bank that advances the money.

4. Delivery Order

The 'delivery order' is an order addressed to the warehouse keeper where the goods are stored to deliver the goods mentioned therein to a particular person. A banker granting an advance on the security of such an instrument is well advised to get the goods transferred into his name. It is instructive to note that the borrower may issue a second delivery order to another person, and if such a person has no notice of the bank's claim, he may get delivery of the goods by producing his copy of the delivery order.

5. Way Bill or Truck Receipt

The banker has operational responsibility to take utmost precautions while advancing money on the security of these documents. If at all the

bank is granting an advance on the security of a 'way bill', it should ensure that that the carrier company which has issued the way bill is in the approved list of the Nigerian Postal authority, which has the responsibility of registering all cargo companies in the country. In order to safeguard the interests of the banks in general, NIPOST has laid down certain norms for the operations of all cargo companies operating in the country.

SELF-ASSESSMENT EXERCISE 3

Mention and discuss various types of documents that are associated with produce and goods.

4.0 CONCLUSION

From our discussion in this unit, we have espoused on the fact that produces and goods can be taken as securities for bank advances. Nevertheless, banks should take necessary steps to ensure that they are not shortchanged or outsmarted by the loan beneficiaries. Therefore, they should ensure that necessary documentation are carried out on the agreement and transfer of title and property on such goods and produce.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed: rationale for taking produce and goods as securities; documents of title to goods; right of lien and right of stoppage in transit; and types of documents associated with produce and goods. In the next study unit, we shall discuss guarantees for loan and advances.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Differentiate title to goods and right of lien.
2. Mention and discuss types of documents associated with produce and goods.

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UNIT 5 GUARANTEES FOR LOANS AND ADVANCES

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we have discussed the use of produce of goods as securities, just like other collateral securities, for bank advances to customers. Bankers are generally careful to secure advances granted by them by insisting on adequate acceptable collateral securities. However, in some cases the bank may grant advances on the basis of personal security of the borrower, which is complemented by the guarantee of some other persons. In this light, such advances to the customers are not secured. In this study unit, therefore, the discussion is on the nature and legal aspects of guarantees.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- discuss the nature of guarantee for advances
- differentiate between guarantee and indemnity
- mention and explain kinds of guarantee
- identify circumstances that can vitiate the liability a guarantor
- discuss the termination of guarantee.

3.0 MAIN CONTENT

3.1 Meaning of Guarantee

A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person in case of default. The person

who gives the guarantee is called the ¯*surety* or *guarantor*, the person for whom the guarantee is given is called the *principal debtor* and the person to whom the guarantee is given is called the *creditor*. Basically, a guarantee must be evidenced by a letter accompanied by passport photograph of the guarantor, in the banking system in Nigeria.

Hence in a contract of guarantee there are three parties such as the surety, the principal debtor and the creditor. For instance, if Ado guarantees that Bello will repay the loan granted to him by GT Bank within a stated period and promises the bank that in case of default on the part of Bello, Ado himself will repay the loan, it is a contract of guarantee. Here Ado becomes the surety or the guarantor while Bello is the principal debtor and GT Bank is the creditor. This implies that the liability of Ado, the guarantee is dependent on the default of Bello to repay the loan to GT Bank.

3.1.1 Differentiation between Contract of Guarantee and Contract of Indemnity

A contract of guarantee is different from the contract of indemnity. A contract of indemnity is a contract by which one party promises to save the other from loss caused to him by the conduct of either the promisor himself, or by the conduct of any other person. For instance, in case of loss of a railway way bill, the consignee will be required to give an indemnity bond by which he undertakes to compensate the railway company for any loss which the latter may have to suffer owing to delivering the goods without the production of the railway bill. There are only two parties in a contract of indemnity such as the indemnifier (or the promisor) and the promisee (or the insured or the party indemnified).

On the other hand, in a contract of guarantee, there are three parties such as the guarantor, the principal debtor and the creditor; as have been identified and discussed above. Basically, the primary liability is that of the principal debtor. The liability of the guarantor is collateral or secondary, which is a contingency liability per se. Therefore, the guarantor's liability only arises only when the principal debtor makes a default.

In the case of a contract of indemnity, the indemnifier is the only person who becomes liable to the indemnified if the latter suffers a loss on account of his doing something at the express desire of the former. A banker can safeguard his interests against loss arising from non-payment or non-performance of an obligation either by obtaining a guarantee or an indemnity from a third party. But in a contract of guarantee, if the principal debtor defaults by non-payment to the creditor, the guarantor,

on such payment, is entitled in law to proceed against the principal debtor in his own right. In the case of a contract of indemnity, the indemnifier cannot sue third parties in his own name unless there is an assignment. He has to bring the suit in the name of the indemnified.

The indemnified has the right to recover from the indemnifier:

(a) all damages which the former may be compelled to pay in any suit in respect of any matter to which the promise to the indemnifier applies,

(b) all costs which the former may be compelled to pay in bringing or defending such suits, provided he did not contravene the orders of the indemnifier or acted in such a way as a prudent man would not under similar circumstances, and

(c) all amounts which may have been paid under the terms of any compromise of any such suit.

SELF-ASSESSMENT EXERCISE 1

Differentiate between guarantee and indemnity.

3.1.2 Kinds of Guarantees

Basically, a contract of guarantee may be either (a) simple (specific) or (b) continuing. In the case of a simple guarantee, it covers only a single transaction and in the case of a continuing guarantee it extends to a series of transactions. It is instructive to note herein that a continuing guarantee may be revoked at any time by the guarantor for future transactions by due notice to the creditor.

Further, in the absence of any contract to the contrary, the death of the guarantor operates, as a revocation of a continuing guarantee as regards future transactions. Nevertheless, the legal representatives of the deceased guarantor will be liable for all transactions guaranteed by him before his death.

3.2 Guarantees as Banker's Security

Prior to the acceptance of a guarantee as a security, the banker has to assess carefully the three Cs, which imply Character, Capacity and Capital of the guarantor. The initial and continued solvency of the guarantor and the completeness of the 'guarantee bond' are of special importance. Bankers generally use printed forms containing detailed clauses to safeguard their interests. In case of doubt regarding the

continued solvency of the guarantor, collateral securities are often insisted upon. So also, in the case of a guarantor with only a fixed income which is terminating at his death, the banker would be well advised to take out an insurance policy on the life of the guarantor.

Circumstances under which Guarantor will be discharged from his Liability include the following:

1. Variance in terms of contract

Any variance, made without the guarantor's consent, in terms of the contract between the principal debtor and the creditor, discharges the guarantor as to transactions subsequent to the variance.

2. **Release or discharge of the principal debtor**

The guarantor is discharged by any contract between the creditor and the principal debtor by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.

Furthermore, it is instructive to note that a release of any property charged to meet one of the surety's contingent liability will discharge the co-sureties. In *Smith Vs Wood*, it was held that the release of the properties of one of the sureties by the creditor had brought a substantial alteration in the contract connecting the parties *inter se* and had also deprived the co-sureties of the right to have all the properties pledged which caused the debt to fall on all the properties. Hence, the co-sureties who had not consented to the alteration were held to be discharged.

Again, the creditor's forbearance to sue does not discharge the surety. Mere forbearance on the part of the creditor to sue the principal debtor or to enforce any other remedy against him does not, in the absence of any provision to the contrary in the guarantee, discharge the surety. But a release of any property charged to meet the principal debtor's liability will have the effect of the creditor prejudicing the interests of the surety.

3. Compounds with, gives time to or agrees not to sue, principal debtor

A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or promises not to sue the principal debtor, discharges the surety unless the surety assents to such contract. Relatedly, where a contract to give time to the principal debtor is made by the creditor with a third person, and not with the principal debtor, the surety is not discharged.

4. Creditor's act or omission impairing surety's eventual remedy

When the creditor carries out any act which is inconsistent with the right of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety against the principal debtor is thereby impaired, the surety is discharged.

5. Guarantee obtained either by misrepresentation or by concealment

Any guarantee which has been obtained by means of either misrepresentation by the creditor or with his knowledge and assent, concerning a material part of the transaction is invalid. Any guarantee which the creditor has obtained by means of keeping silent regarding the material circumstances is invalid.

In addition, where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that person does not join.

SELF-ASSESSMENT EXERCISE 2

What are the circumstances under which guarantor can be discharged from his liability?

3.3 Termination of Guarantee

The termination of a guarantee in respect of future transactions takes place if any of the following events occurs:

1. On receipt of notice of the principal debtor.
2. On the death of the guarantor. It may be repeated here that notice of the death of the guarantor need not be given to the creditor. But where the guarantee bond contains a clause that notice of a certain period must be given to the bank by the legal representatives of the deceased guarantor, the guarantee will continue to bind the estate of the deceased guarantor till the expiry of the notice period.
3. On receipt of notice to the creditor of the guarantor's insolvency.
4. Change in the constitution of the borrower.
5. Notice of demand by the creditor on the guarantor.
6. Notice of revocation by the guarantor to the creditor.

SELF-ASSESSMENT EXERCISE 3

What are the circumstances that can lead to termination of guarantee?

4.0 CONCLUSION

From our discussion in this unit, we have stated that a guarantee involves an undertaking by one person to pay amount of loan in the event the loan beneficiary fails to pay after making use of the funds. This is different from the issue of indemnity because compensation is the issue under indemnity. There are circumstances under which the guarantor's liability can be vitiated if the necessary precautions are not taken into consideration while accepting the undertaking by persons who stand surety for loan beneficiaries.

5.0 SUMMARY

In this course of analysis in this study unit, we have discussed guarantee for loans and advances, and in the process, we have espoused on: meaning of guarantee; types of guarantee; guarantees as bankers' security; and termination of guarantee. In the next study unit, we shall discuss bankruptcy.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Differentiate between right of lien and right of stoppage in transit.
2. Give reasons which can vitiate guarantor's liability.

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UNIT 6 BANKRUPTCY

CONTENTS

1.0 INTRODUCTION

In the previous study unit, we have discussed the use of guarantee for bank loans and advances. In this last study unit, the discussion is on bankruptcy. Corporate entity like a bank can become bankrupt when it becomes technically insolvent because it cannot meet the demands of the depositors due to financial distress. Individuals who owe banks can also become bankrupt due to obvious reasons. The process for the recovery of debts when an individual or company becomes bankrupt forms an integral part of this study unit.

2.0 OBJECTIVES

At the end of this study unit, you should be able to:

- explain bankruptcy
- discuss financial distress in relation to bankruptcy
- differentiate between financial distress and insolvency
- mention and explain factors leading to bankruptcy in banking industry
- discuss debt restructuring in relation to bankruptcy
- explain process in individual bankruptcy to recover debts.

3.0 MAIN CONTENT

3.1 Meaning of Bankruptcy

The term bankruptcy refers to a legal status of a company or other entities such as banks that cannot meet its external financial obligations or cannot repay the debts it owes to creditors. In most jurisdictions, bankruptcy is imposed by a court order, which is often initiated by the debtor. But in the banking industry, the collapse (or bankruptcy) of banks is normally pronounced by the regulatory authorities who then take and entrust the administration of their assets and liabilities. For instance, in Nigeria, the apex bank (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) have such responsibility. The latter then dispose of the assets of the bankrupt banks and then pay the depositors.

From above, it implies that bankruptcy means insolvency, can arise from a condition where a company cannot meet or has difficulty paying off its financial obligations to its creditors. The chance of financial distress increases when a firm has high fixed costs, illiquid assets, or revenues that are sensitive to economic downturns.

A company under financial distress can incur costs related to the situation, such as more expensive financing, opportunity costs of projects and less productive employees. The firm's cost of borrowing additional capital will usually increase, making it more difficult and expensive to raise the much needed funds. In an effort to satisfy short-term obligations, management might pass on profitable longer-term projects. Employees of a distressed firm usually have lower morale and higher stress caused by the increased chance of bankruptcy, which would force them out of their jobs. Such workers can be less productive when under such a burden.

SELF-ASSESSMENT EXERCISE 1

Explain the term bankruptcy.

3.2 FINANCIAL DISTRESS AND BANKRUPTCY

3.2.1Financial Distress

Financial distress occurs when a firm does not have enough cash to meet its current obligations. During financial distress, a firm must make decisions such as selling off assets to cover its cash shortfall. These decisions may erode the value of the firm, and are choices the firm would not make without the presence of a cash shortfall.

Firms may deal with financial distress in many ways. In addition to selling off assets, a firm may also reduce capital spending and research and development. The firm may also undergo a financial restructuring by negotiating with banks and other creditors, exchanging its equity for outstanding debt, and filing for bankruptcy protection or bankruptcy.

3.2.2 Insolvency

A firm will go into bankruptcy when it becomes insolvent, and a firm can be insolvent in two ways. Stock-based insolvency occurs when the firm's debt is greater than the firm's net assets. As a result, the firm will have a negative value for its equity. Flow-based insolvency occurs when the firm's cash flows drop below its current contractual obligations.

3.2.3 Bankruptcy

When a firm files a voluntary petition for bankruptcy, or is forced into bankruptcy by an involuntary petition filed against it, a trustee-in-bankruptcy will be elected by the firm's creditors to administrate the liquidation of the firm's assets. Typically the claims against the firm will be paid out from the proceeds from selling the assets in the following order:

Administrative and other expenses for bankruptcy
Wages, salaries and commissions
Government tax claims
Payments for rent on premises
Judgments on claims for employee
Unsecured creditors
Preferred shareholders
Common shareholders

The secured creditors are paid out of the proceeds from the sale of specific assets. Any amount owed to secured creditors once these specified assets are liquidated is lumped in with unsecured creditors.

SELF-ASSESSMENT EXERCISE 2

Differentiate between financial distress and insolvency.

3.3 Factors That Can Lead to Bankruptcy in Banking Industry

1. High Government Borrowing:

In respect of government domestic borrowings, commercial banks are normally required to hold as statutory liquidity reserves (LR) certain percentage of their deposits in form of government securities, in addition

to the required cash reserve requirement (CRR), which eat into their liquidity position.

Participation in the open market operations market by subscribing to treasury certificates and treasury bills can result in low returns on bank's portfolio, dis-intermediation in the banking system because of the growth of a parallel economy, market segmentation (banks vis-à-vis non-bank), and dispersion in interest rate structure.

2. Credit Controls

The system of credit ceiling being repressive, as the magnitude of credit flows to the private sector was determined only after accommodating public sector credit requirements. In addition, it also tends to accommodate established borrowers even if they were simply meant to rollover their loans, as banks were generally not willing to incur the cost of screening and evaluating new projects.

With these ceilings in place, the practice of accruing interest on infected loans by banks becomes very damaging. In the event that unrealized income is liable to taxation, it tends to reduce banks' ability to augment their capital base and to extend new loans.

3. Credit Allocation

Most of the directed credit programmes do result in low rates of returns and large non-performing loans. It is also difficult to ensure that actual intended beneficiaries are using the credit facilities. Mandatory credit targets at concessional rates also reduced the profitability of the banks.

4. Interest Rates

Floors on deposit rates and ceilings on lending rates of commercial banks discourage savings and the real interest rate on deposits remained virtually negative for most of the time. This can lead to financial dis-intermediation.

5. Limited Competition

A limited competition due to entry restrictions (such as abnormal N25 billion for capitalization for commercial banks) on new banks and restrained activities of foreign banks hampered the development of the financial system, which affect the banking industry due to non-availability of inter-bank credits.

6. Abnormal Overhead Cost

Abnormal overhead cost of operations of commercial banks can led to financial distress, which can lead to bankruptcy resulting from collapse of some banks and eventual liquidation.

7. Inefficient Operations

The use of unqualified personnel by commercial banks, and excess staff strength, the banking operations can lead to serious inefficiency. For instance, some commercial banks in Nigeria are known to be using unqualified personnel due to family connection and other sentiments and the scenario has resulted in inefficiency, loss of funds and eventual collapse (bankruptcy) in recent years.

8. High Level of Malpractices

Another area that can lead to the collapse of banks, which can spell bankruptcy is the malpractice in their operations. In the face of some daunting problems militating against the operational efficiency of the consolidated banks in Nigeria, for instance, they could not generate appropriate level of income to meet their external obligations. In order to boost their income, sharp malpractices by management teams and boards of the banking entities became rampant in the industry. Such malpractices were manifested in round-tripping in foreign exchange transactions, excessive customer charges, falsification of records, and adoption of unethical methods of poaching customers.

9. Pervasiveness of Insider Related Lending

Some banks in Nigeria, for instance, experienced pervasiveness of family and related party affiliations even after the consolidation exercise in the banking industry. Relatedly, there is the problem of lack of transparency as a result of the diversification in bank ownership after the consolidation. The situation resulted in huge levels of insider-abuses and connected lending to members of management and their directors. The scenario led to the collapse of some consolidated banks in the country.

10. Falsification and Concealment of Material Operational Issues

Pervasiveness in rendition of false operational returns to the regulatory authorities by the consolidated banks in Nigeria, for instance, coupled with concealment of vital information from examiners became endemic in the banking industry. These detrimental practices were used to prevent timely detection of the unhealthy situations in the operations of

the banks arising from lack of transparency and pressure to boost income.

Similarly, pervasiveness in concealment of material issues in banking operations in areas of high magnitude of frauds, mixing up of family and business interests, high magnitude of non-performing loans (toxic assets), and award of bogus allowances to board members can and has led to the collapse of some banks. Hence these unwholesome banking practices coupled with poor risk management strategies, ineffective board audit committees, and inadequate operational and financial controls have resulted in destroying the fortunes of some banks and invariably bankruptcy and total collapse.

SELF-ASSESSMENT EXERCISE 3

Enumerate and explain the factors that can lead to bankruptcy in banking industry.

3.4 Bankruptcy and Debt Restructuring

3.4.1 Bankrupt Proceeding to Recover Debts

The principal focus of modern insolvency or bankruptcy is on business debt restructuring. Current practices no longer rest on the elimination of insolvent entities but on the remodeling of the financial and organisational structure of debtors experiencing financial distress so as to permit the rehabilitation and continuation of their business (Reifner *et al.*, 2003; Gerhardt, 2009; Frade, 2010).

An important issue in respect of individual or corporate debts is that, it is insufficient for banks to merely dismiss debts after a certain period. Rather, it is important to assess the underlying problems and to minimise the risk of financial distress reoccurring. Hence banks are advised to initiate fundamental actions such as:

i) Debt advice;
ii) A supervised rehabilitation period;
iii) Financial education and help to find sources of income towards repayment of outstanding debts;
iv) Involvement of the bank staff in improving the management and operations of the debtor company;
v) Advice on cost reduction measures in the debtor company's operations; and
vi) Forced divestment of some operations and sale of assets to generate funds towards resuscitating the bankrupt company.

In some cases, debt discharge is conditioned by a partial payment obligation and by a number of requirements concerning the debtor's behaviour. A bankruptcy regulation may provide for debt settlement plans that can result in a reduction of the debt (maximally half of the amount) or an extension of the payment period of maximally five years (Gerhardt, 2009), but it may not foresee debt discharge.

Fraudulent declaration of bankruptcy can occur on the part of individuals and companies. Such fraudulent practices in relation to bankruptcy are regarded as criminal acts under bankruptcy statutes. Some firms and managers do engage in concealment of assets, concealment or destruction of documents, conflicts of interest, fraudulent claims, false statements or declarations, and fee fixing or redistribution arrangements.

Falsifications on bankruptcy forms often constitute serious crime. The engagement in multiple filings on bankruptcy is not in and of themselves criminal, but such action may violate provisions of bankruptcy regulations. All assets must be disclosed in bankruptcy schedules whether or not the debtor believes the asset has a net value.
The reason is that once a bankruptcy petition is filed by any company, it is for the creditors, not the debtor, to decide whether a particular asset has value. The future ramifications of omitting assets from schedules can be quite serious for the offending debtor. In some countries, a closed bankruptcy may be reopened by motion of a creditor or the trustee if a debtor attempts to later assert ownership of such an "unscheduled asset" after being discharged of all debt in the bankruptcy.

The trustee may then seize the asset and liquidate it for the benefit of the (formerly discharged) creditors. Whether or not a concealment of such an asset should also be considered for prosecution as fraud depends on the discretion of the judge.

A person or debtor can declare himself or herself bankrupt by lodging a debtor's petition. A person can also be made bankrupt after a creditor's petition. All bankrupts are required to lodge a statement of affairs document with appropriate authorities detailing important information about their assets and liabilities. A bankruptcy cannot be annulled until this document has been lodged.

SELF-ASSESSMENT EXERCISE 4

Discuss the bankrupt proceeding to recover debts.

3.4.2 Proceeding in Individual Bankruptcy to Recover Debts

In the case of individual bankrupt, the realisation of funds in bankruptcy usually comes from two main sources: the bankrupt's assets and the bankrupt's income. There may be some certain assets that are protected, referred to as "protected assets". Such assets include household furniture and appliances, tools of the trade and vehicles up to a certain value. All other assets of value will be sold. If a house or car is above a certain value, the bankrupt can buy the interest back from the estate in order to keep the asset. If the bankrupt does not do this, the interest vests in the estate and the trustee is able to take possession of the asset and sell it.
The bankrupt will have to pay income contributions if his or her income is above a certain threshold. The income contributions liability is calculated by halving the amount of income that exceeds the threshold. In the event that the bankrupt fails to pay the contributions due, the trustee can issue a notice to garnishee the bankrupt's income.

Bankruptcies can be annulled prior to the expiration of the normal regulated period, which in some cases takes years, if all debts are paid out in full. Sometimes a bankrupt may be able to raise enough funds to make an offer of composition to creditors, which would have the effect of paying the creditor some of the money they are owed. In the event that the creditor accepts the offer, the bankruptcy can be annulled after the funds are received.

When the bankruptcy is annulled or the bankrupt has been automatically discharged, the bankrupt's credit report status will be shown as "discharged bankrupt" for some years. The number of years varies depending on the company issuing the report, but the report will eventually cease to record that information.

4.0 CONCLUSION

Bankruptcy involves a legal status of a companies or individuals in the event that they cannot meet their external financial obligations or cannot repay the debts they owe to their creditors. In most cases, bankruptcy is imposed by a court order, which is often initiated by the debtor. Financial distress in bank operations can lead to bankruptcy. In the event of bankruptcy, there is a basic proceeding that should be initiated and followed towards the recovering of debts either from an individual or a company that is declared bankrupt.

5.0 SUMMARY

In this course of analysis in this last study unit, we have discussed bankruptcy, and in the process, we have espoused on: Meaning of

Bankruptcy; Financial Distress and Bankruptcy; Financial Distress; Insolvency; Bankruptcy; Factors That Can Lead to Bankruptcy in Banking Industry; Bankruptcy and Debt Restructuring; Bankrupt Proceeding to Recover Debts; and Proceeding in Individual Bankruptcy to Recover Debts.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define bankruptcy and differentiate between financial distress and insolvency.
2. Discuss the proceedings in recovering of debts in bankruptcy.

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