PRINCIPLES & PRACTICES OF BANKING

INDIAN INSTITUTE OF BANKING & FINANCE

macmillan education

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INDIAN INSTITUTE OF BANKING & FINANCE

(ISO 9001:2015 Certified)
Kohinoor City, Commercial-II, Tower-1, 2nd & 3rd Floor,
Kirol Road, Off-L.B.S. Marg, Kurla-West,
Mumbai-400070

Established on 30th April 1928

MISSION

- To develop professionally qualified and competent bankers and finance professionals primarily through a process of education, training, examination, consultancy/counselling and continuing professional development programs.

VISION

- To be the premier Institute for developing and nurturing competent professionals in banking and finance field.

OBJECTIVES

- To facilitate study of theory and practice of banking and finance.
- To test and certify attainment of competence in the profession of banking and finance.
- To collect, analyse and provide information needed by the professionals in banking and finance.
- To promote continuous professional development.
- To promote and undertake research relating to Operations, Products, Instruments, Processes, etc., in banking and finance and to encourage innovation and creativity among finance professionals so that they could face competition and succeed.

COMMITTED TO PROFESSIONAL EXCELLENCE

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PRINCIPLES & PRACTICES OF BANKING

(For JAIIB/Diploma in Banking & Finance Examination)

Indian Institute of Banking & Finance

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PRINCIPLES & PRACTICES OF BANKING

First Edition (2023)

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FOREWORD

Formal education will make you a living; self-education will make you a fortune.

–Jim Rohn

The banking sector, currently, is experiencing a transformation catalysed by digitalization and information explosion with the customer as the focal point. Besides, competition from NBFCs, FinTechs, changing business models, growing importance of risk and compliance have contributed to this radical shift. Such an ever-evolving ecosystem requires strategic agility and constant upgradation of skill levels on the part of the Banking & Finance professionals to chart a clear pathway for their professional development.

The mission of the Indian Institute of Banking & Finance is to develop professionally qualified and competent bankers and finance executives primarily through a process of education, training, examination, counseling and continuing professional development programs. In line with the Mission, the Institute has been offering a bouquet of courses and certifications for capacity building of the banking personnel.

The flagship courses/examinations offered by the Institute are the JAIIB, CAIIB and the Diploma in Banking & Finance (DB&F) which have gained wide recognition among banks and financial institutions. With banking witnessing tectonic shifts, there was an imperative need to revisit the existing syllabi for the flagship courses.

The pivotal point for revising the syllabi was to ensure that, in addition to acquiring basic knowledge, the candidates develop concept-based skills for keeping pace with the developments happening in the financial ecosystem and to ensure greater value addition to the flagship courses and to make them more practical and contemporary. This will culminate in creating a rich pool of knowledgeable and competent banking & finance professionals who are capable of contributing to the sustainable growth of their organizations.

Keeping in view the above objectives, the Institute had constituted a high-level Syllabi Revision Committee comprising of members from public sector banks, private sector banks, co-operative banks and academicians. On the basis of the feedback received from various banks and changes suggested by the Committee, the syllabi of JAIIB & CAIIB have since been finalized.

The revised JAIIB syllabi will now have four compulsory subjects as under:

1. Indian Economy & Indian Financial System
2. Principles & Practices of Banking
3. Accounting & Financial Management for Bankers
4. Retail Banking & Wealth Management

The new subject on Indian Economy & Indian Financial System will cover the basics of economics and financial system prevalent in India. This will familiarise the candidates with the evolving financial ecosystem of the country.

Insofar as the book on Accounting & Financial Management is concerned, two new modules viz Financial Management and Taxation & Fundamentals of Costing have been introduced. With bankers having to cater to the requirements of varied industries, it is imperative that they have an underlying understanding of the relationships between cost accounting, financial accounting, management accounting and financial management. Some of the other topics that have been covered are Cost of Capital, Equipment Leasing, GST, Standard Costing, Marginal Costing, Budgetary Control system etc.

The books on Principles & Practices of Banking and Retail Banking & Wealth Management have been thoroughly revised and updated.

As is the practice followed by the Institute, a dedicated courseware for every paper/subject is published. The present courseware on Principles and Practices of Banking has now been authored in line with the revised syllabus for the subject. The book follows the same modular approach adopted by the Institute in the earlier editions/publications.

While the Institute is committed to revise and update the courseware from time to time, the book should, however, not be considered as the only source of information / reading material while preparing for the examinations due to rapid changes witnessed in all the areas affecting banking & finance. The students have to keep themselves abreast with the current developments by referring to economic newspapers/ journals, articles, books and Government / Regulators' publications / websites etc. Questions will be based on the recent developments related to the syllabus.

Considering that the courseware cannot be published frequently, the Institute will continue the practice of keeping candidates informed about the latest developments by placing important updates/Master Circulars/ Master Directions on its website and through publications like IIBF Vision, Bank Quest, etc.

The courseware has been updated with the help of Subject Matter Experts (SMEs) drawn from respective fields and vetted by practitioners to ensure accuracy and correctness. The Institute acknowledges with gratitude the valuable contributions rendered by the SMEs in updating/vetting the courseware.

We welcome suggestions for improvement of the courseware.

Mumbai
2023

Biswa Ketan Das
Chief Executive Officer

RECOMMENDED READING

The Institute has prepared comprehensive courseware in the form of study kits to facilitate preparation for the examination without intervention of the teacher. An attempt has been made to cover fully the syllabus prescribed for each module/subject and the presentation of topics may not always be in the same sequence as given in the syllabus.

Candidates are also expected to take note of all the latest developments relating to the subject covered in the syllabus by referring to Financial Papers, Economic Journals, Latest Books and Publications in the subjects concerned.

PRINCIPLES & PRACTICES OF BANKING
SYLLABUS

MODULE A: GENERAL BANKING OPERATIONS

Banker-Customer Relationship

Requirements to be Called a Bank, Banker-Customer Relationship, Bank as a Trustee, Bailee-Bailor Relationship, Agent-Principal Relationship, Lessor and Lessee, Indemnifier and Indemnified, Different Deposit Products or Services, Services to Customers and Investors

AML-KYC Guidelines

Money Laundering & Financing of Terrorism Risks, AML Framework in India, Know Your Customer Policy, Organisational Set-up for AML, Obligations under PMLA, Risk Management, Obligations under International Agreements, FATF Identified Jurisdictions, Correspondent Banks, Reporting Under FATCA/ CRS, Reporting Obligations, Implications of Non-compliance of PMLA Obligations, Secrecy Obligations

Operational Aspects of KYC

Know Your Customers (KYC) Norms, Wire Transfers, Other Operations - Regulations, Central KYC Records Registry (CKYCR), Monitoring of Transactions

Opening Accounts of Various Types of Customers

Personal Accounts, Accounts of Other Customers, Norms for Opening Current Accounts, Obtaining Photographs of Account Holders, Legal Entity Identifier

Operational Aspects of Deposit Accounts

Salient Feature of Deposit Accounts, Interest on Deposit Accounts, Prohibitions & Exemptions, Inoperative Accounts & Unclaimed Deposits, Operational Instructions in Joint Accounts, Nomination Facility, Other Operational Guidelines, Attachment Orders, Procedure for Submission of Records to Statutory Authorities

Operational Aspects of Handling Clearing/Collection/Cash

Cheque Truncation System (CTS), RBI Guidelines on Collection of Instruments, Cash and its Custody, Security Arrangements at Branches and ATMs

Banker's Special Relationship

Mandate – Definition, Power of Attorney (POA) – Definition, Banker's Lien, Right of Set-off, Right of Appropriation

Foreign Exchange Remittance Facilities for Individuals

Evolution of FEMA, Definitions, Bringing in and Taking out Foreign Exchange, Inward Remittances, Outward Remittances, Indo - Nepal Remittance Scheme

Operational Aspects of NRI Business

Permitted Accounts in India for NRIs and PIOs, Accounts in India of Foreign Nationals Visiting India, Special Non-Resident Rupee Account – SNRR Account, Remittance of Assets Held by NRIs/ PIOs, Acquisition and Transfer of Immovable Property in India by a Non-Resident Indian (NRI), Creation of Charge on Immovable Property in India, Repatriation of Income and Sale Proceeds of Assets Held Abroad by NRIs, Investments by NRIs/ PIOs

Foreign Currency Accounts for Residents and Other Aspects

Types of Accounts Permitted, Foreign Currency Denominated Accounts in India, Permitted Foreign Currency Accounts Outside India, Remittance of Assets by Foreign Nationals not Being PIOs, Modes of Acquiring Property Outside India by a Resident, Foreign Contribution (Regulation) Act 2010

Cash Management Services and Its Importance

Developments in CMS, Importance of Cash Management System, Types of Cash Management Services, Challenges and Issues

Payment and Collection of Cheques and Other Negotiable Instruments

Negotiable Instruments Act, Payment of a Cheque, Payment in due course – Section 10, Liability of the Paying Bank – Section 31, Collection of Cheques – Duties of a Collecting Bank, Endorsement of Cheques, Crossing of Cheques, Forged Instruments, Bouncing (Dishonour) of Cheques, Cheque Truncation System

Responsibility of Paying Bank

Negotiable Instruments Act and Paying Banks, Liability of Paying Banker when Customer's Signature on the Cheque is Forged, Payment to be in Due Course for Bank to Seek Protection, Payment in Good Faith without Negligence of an Instrument on which Alteration is not Apparent, Payment by Bank Under Mistake Whether Recoverable, Cheque Truncation

Responsibility of Collecting Bank

Statutory Protection to Collecting Bank, Duties of the Collecting Bank

Ancillary Services

Remittances: Introduction, Demand Drafts (DD) and Banker's Cheques (BC), Mail Transfer (MT), Telegraphic Transfer (TT), National Electronic Funds Transfer System (NEFT), Real Time Gross Settlement System (RTGS), Electronic Benefit Transfer (EBT) Scheme, Mobile Banking in India, Electronic/Digital Payments, Safe Deposit Lockers, Portfolio Management Services, Merchant Banking, Government Business, Levying of Service Charges

Financial Inclusion & Financial Literacy

Financial Inclusion by Extension of Banking Services, Use of Mobiles/Tablets in Financial Inclusion Drive, Financial Literacy, Rural Self Employment Training Institutes (RSETI)

Customer Service Guidelines

Customer Service in Banks, Policy for General Management of the Branches, ATM Operations, Security Issues and Risk Mitigation Measures, Service at the Counters, Information to the Customers, Special Arrangements at Branches, Other Provisions

Duties & Rights of a Banker and Customer Rights

Duty of Secrecy & Confidentiality, Duty of Reasonable Care, Garnishee or Attachment Order, Bank's Rights, Customer Awareness, Banking Codes and Standards Board of India, Obligations on the Customer

Grievance Redressal & RBI Integrated Ombudsman Scheme 2021

Model Policy on Grievance Redressal, Internal Machinery to Handle Customer Complaints/ Grievances, The RBI - Integrated Ombudsman Scheme

The Consumer Protection Act, 2019: Preamble, Extent and Definitions

Purpose of The Act, Preamble and Extent, Act not Overriding on Any Other Law, Salient New Aspects of CPA 2019, Definitions, Various Fora, Consumer Protection Councils, Central Consumer Protection Authority, Consumer Disputes Redressal Commissions, Jurisdictions of Commissions, Complaints to District

Commissions, Complaints to State Commissions/ National Commission, Appeals Against Orders of District/ State Commission, Other Aspects, Mediation Process, Product Liability, Unfair Contracts, Data Protection, The CPA 2019 and Banking Services

The Right to Information Act, 2005

Applicability, Definitions, Right to Information, Obligations of Public Authorities, Designation of Public Information Officers, Procedure for Obtaining Information, Disposal of Request, Appeal, Orders in Appeal, Central Information Commission, State Information Commission, Penalties, Act to Have Overriding Effect

MODULE B: FUNCTIONS OF BANKS

Principles of Lending, Different Types of Borrowers, and Types of Credit Facilities

Principles of Lending, Types of Borrowers, Types of Credit Facilities, Fund Based Working Capital Facilities, Term/ Demand Loans, Non-fund Based Facilities, Other Credit Facilities

Appraisal and Assesement of Credit Facilities

Credit Appraisal, Credit Appraisal techniques, Methods of Assessment of Loans, Assessment of Working Capital, Assessment of Term Loan

Operational Aspects of Loan Accounts

Interest Rates on Loans, Credit Management, Credit Monitoring, Common Operational Terms/Aspects in Loan Functions, Operational Process of Handling Loans, Accounting Aspects of Loan Products, Basic Operating Instructions on Loan Products, Operating Manual for Loans and Advances, Sample Operating Instructions, Operational Aspects of a Few Common Loan Products, Guidelines on Recovery Agents Engaged by Banks, Fair Practices Code for Lenders

Types of Collaterals and Their Characteristics

Effectiveness of Securities, What are 'Secured Loans' and 'Unsecured Loans'?, Types of Securities, Land and Buildings, Goods, Documents of Title to Goods, Advances against Life Insurance Policies, Advance Against Shares, Advance Against Debentures, Loan against Book Debts, Loan against Term Deposits, Loan against Gold Ornaments, Supply Bills, Vehicle Finance

Different Modes of Charging Securities

Meaning and Essentials of a Contract, Contract of Agency, Contract of Bailment, Types of Charges, Registration of Charges

Documentation

Different Types of Documents, Documentation Procedure

Non-Performing Assets/ Stressed Assets

Definition, Income Recognition, Computation of Gross Advances, Gross NPA, Net Advances, and Net NPA, Asset Classification, Provisioning Norms, Writing Off of NPAs, NPA Management – Requirement of Effective Mechanism and Granular Data, Framework for Resolution of Stressed Assets, Prudential Norms Applicable to Restructuring , Other Aspects

Important Laws Relating to Recovery Of Dues

Introduction to Recovery of Debts and Bankruptcy Act, 1993 (DRB), Introduction To SARFAESI Act, Introduction To The Insolvency and Bankruptcy Code, 513, Introduction To The Legal Services Authorities Act, 513, Introduction To The Law of Limitation

Contracts of Indemnity

Contract of Indemnity Defined , Distinctive Features of Indemnity Contract and Guarantee, Rights of an Indemnity Holder, Implied Indemnity, Enforceability of Contract of Indemnity, Scope and Application of Indemnity Contracts to Banks

Contracts of Guarantee & Bank Guarantee

Parties to the Contract, Basic Principles of Contract to be Complied, Consideration, The Liability of the Surety, Continuing Guarantee, Revocation of a Continuing Guarantee, Death of Surety, Variance in Terms of the Contract, Discharge of Principal Debtor, Forbearance to Sue, Surety can Claim His Dues from the Principal Debtor, Security, Implied Promise by the Principal Debtor to Indemnify the Surety, Misrepresentation Made by the Creditor, Co-sureties for the Same Debt, Release of One Co-surety does not Discharge Other, Bank Guarantees, Various Types of Bank Guarantees, Banker's Duty to Honour Guarantee, Issuance of Bank Guarantee – Precautions to be Taken, Payment Under Bank Guarantee – Precautions to be Taken

Letters of Credit

Letters of Credit – General Consideration, Parties to a Letter of Credit, Types of Letters of Credit, Documents Under a Letter of Credit, Uniform Customs and Practices for Documentary Credits – UCPDC 600, Payment Under Letter of Credit – Banks Obligation Primary

Deferred Payment Guarantee

Purpose of Deferred Payment Guarantee, Method of Payment

Laws Relating to Bill Finance

Class of Bills and Laws Governing Bills, Classification of Bills, Various Types of Bill Finance, Bill Finance and Legal Position of a Banker

Personal Finance

Credit Card, Home Loans, Personal Loans, Consumer Loans

Priority Sector Advances

Applicability, Targets/Sub-Targets for Priority Sector, Categories of Priority Sector, Non-Achievement of Priority Sector Targets, Common guidelines for Priority Sector Loans, Other Modes of Lending to Priority Sectors, Other Aspects Related to Priority Sector Lending

Agricultural Finance

Short-Term Loans, Medium/Long-Term Loans, Crop Loan, Revised Scheme for Issue of Kisan Credit Card (KCC), Selected Activities Under Agricultural Financing, Minimum Support Prices Scheme, Prime Minister Fasal Bima Yojana (PMFBY)

Finance to MFIs/Co-Lending Arrangements With NBFCs

Background, Bank Borrowings - Source Of Finance for NBFCS, Bank Finance to NBFCS, Bank Loans to NBFCS for On-Lending, Bank Loans to NBFCS-MFIs, NBFC-MFI – Channelising Agent for Special Government Schemes, Co-Lending by Banks and NBFCS to Priority Sector, Framework for Scale Based Regulation (SBR) for Non-Banking Financial Companies

Micro, Small and Medium Enterprises in India

Aim of MSMEs, Micro, Small and Medium Enterprises Development (MSMED) Act, 667, Policy Package for MSMEs – Credit/Finance, Measures for Promotion, Development and Enhancement of Competitiveness of Micro, Small and Medium Enterprises, Delayed Payments, Trade Receivables Discounting System (TReDS), Performance and Credit Rating Scheme, Credit Guarantee Fund Scheme for Micro and Small Enterprises, Cluster Based Approach in Financing MSMEs, Common Guidelines / Instructions for Lending to MSME Sector

Government Sponsored Schemes

Deendayal Antyodaya Yojana – National Rural Livelihoods Mission (DAY-NRLM), Deendayal Antyodaya Yojana – National Urban Livelihoods Mission (DAY-NULM), Pradhan Mantri Jan Dhan Yojana (PMJDY), MUDRA Loans, Khadi Village Industries Commission (KVIC)

Self-Help Groups

SHG – Definition, Need for SHGs, Forming SHGs, SHGs Under DAY-NRLM/ DAY-NULM Schemes, SHG-Bank Linkage Programme

MODULE C: BANKING TECHNOLOGY

Essentials of Bank Computerisation

Bank Computerisation, Networking Technologies in Banks, Uninterrupted Power System (UPS), Core Banking, Data Warehousing and Data Mining

Operational Aspects of CBS Environment

Functions Performed by CBS, Flow of Transactions in CBS, The Accounting of Transactions in CBS, End of Day (EOD) And Begin of Day (BOD) Operations, End of Day (EOD) Operations, Password Control, Parameter/Master File, Logical Access Control, Operational Aspects of Security Control in CBS, Role and Responsibilities of the Bank Under CBS

Alternate Delivery Channels – Digital Banking

Alternate Delivery Channels, Automated Teller Machines (ATMs), Electromagnetic Cards, Electronic Banking, Customer Protection–Limiting Liability of Customers in Unauthorised Electronic Banking Transactions, Harmonization of Turn Around Time (TAT) and Customer Compensation for Failed Transactions Using Authorised Payment Systems

Data Communication Network and EFT Systems

Data Communications Networks, Network Scenario in India: Major Networks, Emerging Trends in Communications Networks for Banking, Evolution of EFT Systems, Structured Message Transfer System Using SWIFT, Automated Clearing Systems, Two-Level Funds Transfer System, Emergence of Electronic Payment Systems in India

Digital Payment Systems – NPCI

Electronic Clearing Systems in India, National Payment Corporation of India (NPCI), Digital Initiatives by the Government of India

Impact of Technology Adoption and Trends in Banking Technology

Trends in Technology Developments, Role and Uses of Technology Upgradation, Global Trends in Banking Systems, Impact of Information Technology on Banks, Some emerging technology trends in Banking

Security Considerations and Mitigation Measures in Banks

Risk Concern Areas, Different Types of Threats, Control Mechanism, Computer Audit, Information System Audit (IS Audit), Information System Security (IS Security), Modus Operandi of Online Frauds and Cyber Security Awareness, IT Resources Evaluation Requirements, Disaster Recovery Management Objective, Legal Framework for Electronic Transactions Information Technology Act, G. Gopalakrishana Committee Report, Cyber Security Framework in Banks, Integrated Ombudsman Scheme, 2021 by RBI

Operational Aspects of Cyber Crimes/Fraud Risk Management in Cyber Tech

Fraud vs Crime, Phases of an Effective Incident Response Plan

Technology Trends in Banking, e-RUPI, Fintech - RegTech, SupTech, Hashtag Banking etc.

e-RUPI, Fintech/Reg Tech/Sup Tech, Social Media Banking, Hashtag Banking, Account Aggregators, Open Banking

MODULE D: ETHICS IN BANKS AND FINANCIAL INSTITUTIONS

Ethics, Business Ethics & Banking: An Integrated Perspective

Values and Ethics, Ethics and Business Values, Business Ethics – Definition, Principles and Practice, An Ethical Crisis: Is Business Ethics an Oxymoron?, Ethical Foundation of Banking: Finance Depends on Trust, Ethical Foundation of Being a Professional, Banking Ethics in Global Context: Enron and Its Lesson, Global Financial Crisis, Ethics in Indian Context: Satyam and Its Lessons, An Indian Bank Case Study

Ethics at the Individual Level

Values, Norms, Beliefs and Their Role, Core Values: The Value of a Value, Morality and Personal Values, Value – Conflicts: How Should I Live?, Personal Ethics and Business Ethics: Individual Integrity and Responsibility, The Golden Rule, Understanding Right and Wrong: Doing the Right Thing, Ethical Reasoning and Real-World Application, Ethical Dilemmas: Resolving Ethical Dilemmas, A Framework of Ethical Decision-Making

Ethical Dimensions: Employees

Abuse of Official Position: Insider Trading, Proprietary Data, Bribes, etc., Obligations to Third Parties, Job Discrimination, Sexual Harassment, Managing Conflict of Interests, Fair Accounting Practices: Related Party Transactions, HRM Ethics, Principles of Representation and Work Environment, Employees as Ethics Ambassadors & Managers as Ethical Leaders

Work Ethics and the Workplace

What Is Work Ethics? Something Bigger Than the Self, Ethical Behaviour at The Workplace: Benefits, Recognising Ethical Workplaces, Unethical Behaviours: Causes and Remedies, Conducting Personal Business During Office Time, Taking Credit for Others' Work, Ethical Lapses and Organizational Culture, Ethics of a Banker, Whistleblowing in Banks, Whistleblowing Law in India

Banking Ethics: Changing Dynamics

Ethics and Technology, Data Security and Privacy, Intellectual Property Rights, Patents and Proprietary Rights, Ethics of Information Security

CONTENTS

MODULE C: BANKING TECHNOLOGY

MODULE D: ETHICS IN BANKS AND FINANCIAL INSTITUTIONS

MODULE A

GENERAL BANKING OPERATIONS

Unit 1. Banker-Customer Relationship
Unit 2. AML- KYC Guidelines
Unit 3. Operational Aspects of KYC
Unit 4. Opening Accounts of Various Types of Customers
Unit 5. Operational Aspects of Deposit Accounts
Unit 6. Operational Aspects of Handling Clearing/Collection/ Cash
Unit 7. Banker's Special Relationship
Unit 8. Foreign Exchange Remittance Facilities for Individuals
Unit 9. Operational Aspects of NRI Business
Unit 10. Foreign Currency Accounts for Residents and Other Aspects
Unit 11. Cash Management Services and its Importance
Unit 12. Payment and Collection of Cheques and Other Negotiable Instruments
Unit 13. Responsibility of Paying Bank
Unit 14. Responsibility of Collecting Bank
Unit 15. Ancillary Services
Unit 16. Financial Inclusion & Financial Literacy
Unit 17. Customer Service Guidelines
Unit 18. Duties & Rights of a Banker and Customer Rights
Unit 19. Grievance Redressal & RBI Integrated Ombudsman Scheme 2021
Unit 20. The Consumer Protection Act, 2019: Preamble, Extent and Definitions
Unit 21. The Right to Information Act, 2005

UNIT 1

BANKER-CUSTOMER RELATIONSHIP

STRUCTURE

1.0 OBJECTIVES

After reading this Unit, you will:

- Know the requirements of a bank
- Understand various types of relationship between a bank and its customer
- Know different types of deposit products and services
- Know various types of services banks offer to customers and investors

1.1 INTRODUCTION

The basic function of a banker is accepting money from the public by way of deposits and deploying the same by means of loans and investments. Besides, bankers render a variety of services, like providing lockers, keeping articles in safe custody, collecting bills, cheques, etc. Different types of relationships are created between the banker and the customers, depending upon the nature of service rendered.

1.2 REQUIREMENTS TO BE CALLED A BANK

As per Sec. 5(b) of 'the Banking Regulation Act, 1949 (BR Act)', the term '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. Hence, the banker is in the business of accepting deposits from the public and utilising these for the purpose of lending or investment.

Thus essentials to satisfy the requirements of the definition are:

(a) Deposits should be only for lending and investment. Companies accepting deposits for trading or manufacturing are not considered as a bank.
(b) The deposit should be from the public. So, 'Nidhis' multi-benefit societies, co-operative societies that accept deposit from their members are not covered as a bank.
(c) Acceptance of deposit should be in the form of money.

A company incorporated under Indian Companies Act, 1956 or Companies Act, 2013 can be a bank, a banker or a banking company. Under Sec. 5(c) of BR Act, 'Banking Company' means any company that transacts the business of banking in India. Sec. 7(1) of BR Act prohibits use of the words 'banker' or 'banking' or 'banking company' by a company other than a banking company. Sec. 7(2) further prohibits the use of such words by an individual or a group of individuals or a firm.

(a) *Moneylenders are not bankers:* The definition of banker does not include the moneylenders or *mahajans*, *Sahukars* or *Shettys*, because they run their business as individuals or groups of individuals and not as a company registered under the provisions of the Companies Act and BR Act. In the case of Kadiresan Chettiar vs. Ramanathan Chettiar (AIR 1927, Madras 438), it was held that while a moneylender lends his own money, a banker lends money of his customers/depositors.
(b) *Accepting deposits of money from the public:* Every institution carrying out the business of banking must accept the deposits of money from the public and should not confine to the deposits from its members only. In the case entitled *Mahalaxmi Bank Limited* vs. *Registrar of Companies*, it was decided that if a company gave loan to the public but did not accept deposits from the public, it could not be considered as a banking company under Sec. 5 of BR Act.
(c) *Acceptance for the purpose of lending or investment:* An institution accepting deposits of money without any purpose or with a purpose other than lending or investment cannot be termed as a bank.
(d) *Deposit repayable to depositors on demand or otherwise:* Deposits of money may be repayable either on demand or if they are term deposits, on the expiry of the stipulated term or period.

(e) The deposits may be withdrawable by the customers by cheque, draft, order or otherwise.

Banks are also authorised to carry out certain other transactions as provided under Sec.6 of BR Act, 1949, mainly:

(a) Discounting of bills; (b) Collection of cheques and bills; (c) Remittances; (d) Safe custody of articles; (e) Hiring safe deposit lockers; (f) Conducting foreign exchange transactions; (g) Conducting (Central/ State) government transactions; (h) Issuing letters of credit and guarantees.

Besides, banks now a days also undertake following activities:

(i) Wealth Management services; (ii) Project appraisal; (iii) Sale of third party products such as Mutual funds, Life insurance, General insurance; (iv) Executor Trustee services; (v) Acceptance of Central and State Govt. Taxes; (vi) Franking of Stamp duty on documents; (vii) Securities Trading; (viii) Factoring; (ix) Venture Capital financing; (x) Demat services.

1.3 BANKER-CUSTOMER RELATIONSHIP

1.3.1 Introduction

The relationship between a banker and a customer depends upon the nature of services provided by the banker.

1.3.2 Who is a Customer?

Before we understand the banker customer relationship it is necessary to know who is called as a customer. The term 'customer' of a bank is not defined by law. Ordinarily, a person who has an account in a bank is considered as a customer. The legal judgments in the past, however, used to qualify this statement by laying emphasis on the period for which an account had actually been maintained with the bank.

In Sir John Paget's view "to constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business." This definition of a customer of a bank lays emphasis on the duration of the dealings between the banker and the customer and is, therefore, called the 'duration theory'. According to this viewpoint a person does not become a customer of the bank on the opening of an account; he must have been accustomed to deal with the banker before he is designated as a customer. The emphasis on the duration of the bank account is now discarded. According to Dr. Hart, "a customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such." Kerala High Court observed in the case of *Central Bank of India Ltd. Bombay vs. V.Gopinathan Nair and others (A.I.R., 1979, Kerala 74)*: "Broadly speaking, a customer is a person who has the habit of resorting to the same place or person to do business. So far as banking transactions are concerned he is a person whose money has been accepted on the footing that banker will honour up to the amount standing to his credit, irrespective of his connection being of short or long standing."

For the purpose of KYC requirements, a 'Customer' is defined as:

- A person or entity that maintains an account and/or has a business relationship with the bank or conducts a transaction with the bank
- One on whose behalf the account is maintained or a transaction is conducted (i.e. the beneficial owner). [Ref: Prevention of Money Laundering Act, 2002 Sec. 2(fa) – "'Beneficial Owner' means an individual who ultimately owns or controls a client of a reporting entity or the person on whose behalf a transaction is being conducted and includes a person who exercises ultimate effective control over a juridical person"]

- Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- Any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

As per the Prevention of Money Laundering Act, 2022, “client” means a person who is engaged in a financial transaction or activity with a reporting entity and includes a person on whose behalf the person who engaged in the transaction or activity, is acting. A customer of a bank need not necessarily be a natural person. A firm, joint stock company, a society or any separate legal entity (like a partnership firm or an association of persons) may be a customer. Explanation to Sec. 45-Z of BR Act clarifies that “customer” includes a Government department and a corporation incorporated by or under any law.

Since the banker-customer relationship is contractual, it follows that any person who is competent to contract can open a deposit account with a bank branch of his/her choice and convenience.

1.3.3 Debtor-Creditor (Bank is a Debtor and Customer is a Creditor)

When a customer deposits money with his bank, the customer becomes a lender and the bank becomes a borrower. The money handed over to the bank is a debt. The relationship between the banker and the customer is that of a debtor and a creditor. The main features of this relationship are:

(a) The bank is free to use the money in a way most beneficial to it.
(b) The customer should make a demand of payment. The banker is not required to pay voluntarily.
(c) The demand should be made in specified manner, in writing by cheque, draft, withdrawal form, order or otherwise, during working hours.
(d) The creditor (customer) does not have any security from the debtor (bank).
(e) The law of limitation does not begin to run until a demand has been made for repayment, in case of both demand and fixed deposits.

1.3.4 Creditor-Debtor (Bank is a Creditor and Customer is a Debtor)

When the bank lends money to the customer, the customer is the borrower (i.e. a debtor) and the bank is the lender (i.e. a creditor). Lending money is the most important activity of a bank. The resources mobilized by banks are utilized for lending operations. Customer, who borrows money from the bank, owes money to the bank. In the case of any loan/advance account, the banker is the creditor and the customer is the debtor or the borrower. The borrower executes documents and offers security to the bank before utilizing the credit facility.

In addition to these two activities, banks also undertake other activities mentioned in Sec.6 of the Banking Regulation Act. Depending upon the type of services rendered and the nature of the transaction, the banker acts as a bailee, trustee, principal, agent, lessor, custodian, etc.

1.4 BANK AS A TRUSTEE

A trustee is a person or firm that holds and administers property or assets for the benefit of a third party. Trustees are required to make decisions in the beneficiary’s best interests and have a fiduciary responsibility to them, meaning they act in the best interests of the beneficiaries to manage their assets. If a customer keeps certain valuables or securities with the bank for safe-keeping or deposits a certain amount of money for a specific purpose, the banker, besides becoming a bailee, is also a trustee. In the case of Subramanyan Pillai and Others vs. Palai Central Bank Ltd. (AIR 1962 Ker. 210), certain persons deposited ₹2,000 each in the bank as guarantee money to purchase cars. The bank failed before they could get the vehicle. The court was of the view that the bank acted as a trustee and the money should be refunded as preferential debts.

In one case, a customer remitted money for purchase of shares of a company. The bank bought shares in parts, but before completing the rest of the purchase, it failed. It was held that the bank stood in the position of a trustee, and the remitter was entitled to the refund of the unspent amount.

1.5 BAILEE-BAILOR RELATIONSHIP (BANK-BAILEE AND CUSTOMER-BAILOR)

When a customer deposits certain valuables, bonds, securities or other documents with the bank, for their safe custody, the bank, besides becoming a trustee as discussed earlier, also becomes a bailee and the customer is the bailor. According to the terms of Sec. 148 of the Indian Contract Act, 1872, the bank becomes custodian of the securities of the customer and hence as a bailee is liable for any loss caused to the bailor due to its negligence. The finder of lost goods (Sec. 71 Indian Contract Act) should return any increase in goods/animals to the true owner. Under Section 164 (Indian Contract Act), the finder has to take care of such goods as an ordinary prudent man. These are examples of bailee-bailor relationship.

1.6 AGENT-PRINCIPAL RELATIONSHIP (BANK IS AGENT AND CUSTOMER IS PRINCIPAL)

According to Section 182, of the Indian Contract Act, 1872, a principal is a person who delegates authority to another person namely, the agent. Among the ancillary services rendered by the bank are remittance, collection of cheques, bills, to pay regularly, electricity bills, telephone bills, insurance premium, club fees, etc. on behalf of the customers. In these cases, the bank acts as an agent, his principal being the customer. The relationship of agency, terminates on the death, insolvency and lunacy of the customer or on completion of the work assigned. In case of remittances, though the relation is of agency in the case of Traders Bank Ltd vs. S. Kalyan Singh (AIR 1953), Punb p. 195, the High Court has held the relation to be that of debtor-creditor.

1.7 LESSOR AND LESSEE (BANK AS A LESSOR AND CUSTOMER AS A LESSEE)

Section 105 of 'Transfer of Property Act' deals with lease, lesser, lessee. The banks provide safe deposit lockers to the customers for use on lease basis. The relationship here is that of lessor and lessee or of licensor and licensee. The bank shall not be liable for any damage and/or loss of contents of locker arising from natural calamities or Acts of God like earthquake, floods, lightning and thunderstorm or any act that is attributable to the sole fault or negligence of the customer. Banks shall, exercise appropriate care for protection of their locker systems and premises. It has the responsibility to ensure that incidents like fire, theft/burglary/ robbery, dacoity, building collapse do not occur in the bank's premises due to its own shortcomings, negligence and by any act of omission/commission. In instances where loss of contents of locker is due to such incidents or attributable to fraud committed by its employee(s), the banks' liability shall be for an amount equivalent to one hundred times the prevailing annual rent of the safe deposit locker.

1.8 INDEMNIFIER AND INDEMNIFIED (BANK IS INDEMNIFIED OR INDEMNITY HOLDER AND CUSTOMER IS INDEMNIFIER)

A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or the conduct of any other person is a contract of indemnity – Sec. 124 (Indian Contract Act, 1872). In banking, such relationship occurs in transactions of issue of duplicate demand draft, fixed deposit receipt etc. In these cases the person availing the facility will compensate the other for any loss arising from the wrong/excess payment.

1.8.1 Banker Customer Relationship Summarised

The banker – customer relationships are summarized below for different types of transactions.

Transaction	Bank	Customer
Deposit in the bank	Debtor	Creditor
Loan from bank	Creditor	Debtor
Safe custody	Bailee	Bailor
Locker	Lessor	Lessee
Collection of Cheque	Agent	Principal
Purchase of a draft*	Debtor	Creditor
Payee of a draft	Trustee	Beneficiary
Pledge	Pawner (Pledgee)	Pawnee (Pledger)
Mortgage	Mortgagee	Mortgagor
Standing instruction	Agent	Principal
Sale/purchase of securities on behalf of a customer	Agent	Principal
Money deposited but instructions not given for its disposal	Trustee	Beneficiary
Articles left by mistake	Trustee	Beneficiary
Shares given for sale	Agent	Principal
Hypothecation	Hypothecatee	Hypothecator

*As per Haryana and Punjab High court judgment in the case of Traders Banks vs. Kalyan Singh- 1953

1.9 DIFFERENT DEPOSIT PRODUCTS OR SERVICES

1.9.1 Deposit Products

Deposit products consist of a wide variety of financial products whereby, clients deliver (deposit) funds (in cash or digitally) with a financial institution and may earn a financial return depending on the deposit type and duration. Let us know the different types of deposit products offered by banks. Detailed features of various deposit products are discussed in Unit 5.

Types of Deposits

Deposits are normally classified as demand deposits and time deposits.

Demand Deposits	Time Deposits
1. Payable on Demand.	1. Repaid after expiry of the Deposit Period.
2. Low interest rates or no interest.	2. High interest rates, which vary according to period.
3. It includes current, savings, overdue deposits and unclaimed deposits.	3. Time deposits are for a period ranging from 7 days to 120 months period with or without reinvestment plans.

1.9.2 Demand Deposits

Demand deposits are classified into current accounts and savings accounts.

Current Deposits: The deposis in current account are working funds of businesses or enter; rises, and fluctuate widely and are not paid any interest.

Saving Deposits: Savings accounts are to inculcate savings habit and facilitate regular transactions through banking system, and attract interest. These fluctuate, albeit are less volatile.

1.9.3 Time Deposits

Term deposits (TD) are for investing surplus funds for short to long term. TD can have distinguishing features for following parameters:

(i) Mode of interest payment – Periodical or cumulative.
(ii) Mode of investment – in lump sum or in instalment.
(iii) Mode of return of principal – on maturity or in instalment.

TDs are of several types as indicated below:

(i) Fixed Deposits (periodical interest payment)
(ii) Short-term Deposits (of less than a year)
(iii) Reinvestment Deposit Scheme (cumulative interest paid on maturity)
(iv) Recurring Deposit Scheme (periodical deposits made)
(v) Flexi Recurring Deposit (special type of recurring deposit)

1.9.4 Hybrid Deposits or Flexi Deposits

These are a combination of demand and fixed deposits, introduced giving flexibility to customer.

1.9.5 Deposit Products for Non-Resident Indians

Banks also offer special deposit accounts/ schemes for Non Resident Indians, Persons of Indian Origins, and Overseas Citizens of India.

- Non-Resident Ordinary Rupee Account (NRO Account)
- Non-Resident (External) Rupee Account (NRE Account)
- Foreign Currency Non Resident (Bank) Account – FCNR (B) Account

1.10 SERVICES TO CUSTOMERS AND INVESTORS

Banks also provide certain other financial services to meet other needs of customers and investors. These services help in augmenting revenue earnings for the banks.

1.10.1 Merchant Banking

Merchant bankers are financial intermediaries facilitating transfer of capital from those who own it (Investor or Bond Subscriber) to those who use it (Corporates or Governments). They help a corporate in Initial Public Offering (IPO) or a Follow-up Public Offer (FPO), popularly called a Public issue or Private Placement of Debt or Equity.

Merchant bankers assist in introducing or selecting or appointing outside technical consultants in addition to in-house technical personnel for preparation of a detailed project report, market survey report, feasibility studies etc. It also assists in:

(a) Obtaining regulatory clearances from Securities Exchange Board of India (SEBI), the stock exchanges (BSE, NSE), Registrar of Companies etc.
(b) Specifically obtaining clearances from SEBI for the prospectus of the IPO or the FPO.
(c) Planning and timing of the IPO/FPO.
(d) Underwriting of public issue by financial institutions or brokers.
(e) Selection of Principal Broker(s) and Sub-Brokers, lead-book-runners and sub-book runners.
(f) Selecting the Registrar to the issue and fixing their remuneration.
(g) Selecting bankers to the issue that will maintain the bank account for collecting and holding the funds to be raised till successful closure of the issue.
(h) Selecting advertising consultants or agencies for publicity campaigns, investor conferences, analyst conferences and road shows.
(i) Printing and distribution of prospectus/ application forms to brokers/ sub-brokers/book runners.
(j) Making application to stock exchanges for listing of the security.
(k) Monitoring and reporting the progress of the offering to the company and regulatory bodies.

1.10.2 Lease Financing

This means leasing out the capital assets owned by an institution to another company against payment of monthly rents for asset's consumption or use. Here, the finance is provided by the institution (may be a bank too), called Lessor, which does not enjoy the use of asset but is its owner. The lessor is entitled to write off a certain amount of capital cost (i.e. in the form of depreciation charge on the capital asset) against its taxable profits until it is fully written off. While the lessee is benefited by not investing funds in capital cost, the lease charges are permitted to account as revenue expenses in its books of accounts. The lease can also be arranged on any existing freehold asset(s) or long leasehold property by either mortgaging it or by selling it at market price to a leasing company; this leasing company in turn would lease it back to the seller of the asset on lease thus benefiting both the entities. In a lease, the lessee of the equipment does not become the owner thereof.

Advantages to Lessee

(a) Use of asset without incurring the capital cost, thus saving on cost of capital.
(b) Lease rentals are business revenue expense, contracting profits and reducing taxation.
(c) Since there is no capital cost, this does not impact the liability side of the balance sheet.
(d) Credit worthiness of the lessee is maintained at a higher level facilitating it to borrow further.

Disadvantages to Lessee

(a) Ownership of the asset is held with the lessor and not with the lessee.
(b) The asset is permitted to be used for agreed business purposes only; preventing from utilising the asset for alternative business purposes, if any.

(c) Confiscation or repossession of the asset by the lessor on breach of terms and conditions.
(d) If the lessor/owner becomes insolvent or goes into liquidation the asset may be attached by the liquidator.

1.10.3 Plastic Money

Plastic money in the form of credit cards and other types of cards has become a preferred mode of payments. Increasing use of the plastic money, has reduced the need of cash to a significant extent.

(i) Charge Cards

A charge card is an electronic payment card, where the cardholder is not charged interest but needs the user to pay the balance due in full upon receipt of the statement, usually every month. Holders of these cards may have to pay a high annual fee. There are very few issuers of charge cards. Charge cards usually do not have a preset spending limit and the amount allowed to be drawn varies depending on the usage and payment record built up. There are no charges levied on the amount spent apart from the annual fee. Late fee is charged on delayed payments.

(ii) Credit Cards

Credit card facilitates the card holder to utilize sanctioned credit limit primarily for making purchases of goods and services. The difference between a credit card and a charge card is that in case of charge card, the entire outstanding amount is to be paid within the specified period. In case of credit cards, the cardholder has the option to pay only part amount on due date.

(iii) Debit Cards

Debit cards are similar to credit cards in functionalities, except that the transaction amount is debited to the cardholder's account as soon as it is notified to the issuer. Hence it is an instrument facilitating debit to a savings or current account.

(iv) ATM Cards

These are cards issued to the savings/ current account holders for drawing cash from Automated Teller Machines (ATMs) located in the branch or off site. Usually debit cards are also used as ATM cards.

(v) Prepaid Cards

Prepaid cards are loaded with the amount paid by the persons purchasing the cards. These cards can be given to third persons who can use these for making purchases from merchants. Some cards can also be used for withdrawing cash from ATMs.

(vi) Co-branded Cards

A co-branded card is a credit card that a retailer of consumer goods or services issues in partnership with a particular credit card issuer or network. Often bearing the logos of both the credit card company and the retailer, co-branded cards earn merchandise discounts, points, or other rewards when used with the sponsoring merchant, but they can also be used anywhere the cards from that network are accepted.

1.10.4 Electronic Cards/Payment services

As the financial services sector has become technology based and smart phones have become widely prevalent, electronic payment instruments have been introduced. These instruments can be loaded on the smartphones of the customers, like mobile wallet, etc. Various cards are now issued in electronic form also.

1.10.5 Remittance Services

For facilitating funds transfers between two persons, banks were providing services in the form of Demand Drafts (DD), Banker's Cheques (BC)/ Pay Orders (PO), Mail Transfers (MT) and Telegraphic Transfers (TT). With adoption of core banking system for bank operations, these products have become redundant. Transfer products have become technology as stated below:

- National Electronic Funds Transfer (NEFT)
- Real Time Gross Settlement (RTGS)
- Immediate Payment Service (IMPS)
- Unified Payment Interface (UPI) Transfers
- Aadhaar Enabled Payment System (AePS)
- National Automated Clearing House (NACH)

1.10.6 Government Schemes

Banks also serve as the distribution points for several Government Schemes that are aimed at financial inclusion and also providing safe avenues of investment to the common man. Some of the prominent schemes are mentioned below. These products provide commission income to banks, apart from facilitating them to cater to various needs of their customers under one roof.

- Public Provident Fund (PPF)
- National Pension Scheme (NPS)
- Capital Gains Account Scheme 1988 (CGAS)
- Senior Citizens Savings Scheme (SCSS)
- Sukanya Samriddhi Account Scheme, 2019
- RBI Bonds
- Gold Monetisation Scheme, 2015
- Sovereign Gold Bond Scheme (SGB)
- Nominated Agency for Gold Imports
- Atal Pension Yojana
- Pradhan Mantri Vaya Vandana Yojana (PMVVY)
- Pradhan Mantri Suraksha Bima Yojana (PMSBY)
- Stand Up India Scheme
- Pradhan Mantri Jan Dhan Yojana

1.10.7 Third Party Products Sale

With a view to providing one-stop-services to their customers, banks have tapped the opportunity made available through regulatory relaxations for banks to sell third party financial products pertaining mainly to the capital market and insurance sectors. For banks, it is an additional source of revenue. Customers, get financial services at one place. For capital market and insurance sector, it adds to their depth. Some of the major third party products are:

(i) ***Demat Accounts:*** Tie-up with a Depository Participant (DP). Some banks register as a DP.
(ii) ***Trading Account:*** Tie-up with a Stock Broker.
(iii) ***Three-in-One Account:*** Linked Demat Account - Trading Account - Savings/ Current Account.
(iv) ***Mutal Funds:*** Tie-up with various mutual fund companies.
(v) ***Life Insurance Policy:*** Tie-up with a life insurance company.

(vi) ***Health Insurance Policy:*** Tie-up with a health insurance company.
(vii) ***Vehicle Insurance, House Insurance, etc.:*** Tie-up with a general insurance company.

1.10.8 Safe Custody or Trusteeship Services

Banks and bankers enjoy tremendous public trust. Banks have therefore offered certain services that leverages on this public confidence. Certain services that banks provide in this context are as follows:

(i) ***Safe Custody of articles, documents, etc.:*** Valuable articles/ documents are left in the custody of banks for safekeeping.
(ii) ***Hiring out safe deposit lockers:*** Banks hire out safe deposit lockers for safe keeping of valuables (ornaments, gold, documents, etc).
(iii) ***Escrow account:*** Such accounts are used when a party wants to exercise some control on the use of the funds received in the account in the name of another party.
(iv) ***Escrow services for document:*** There are situations when certain parties to a transaction want to have joint control of a document until certain conditions are fulfilled.
(v) ***Trusteeship:*** Banks offer trusteeship services for handling of certain funds or assets.
(vi) ***Executorship:*** Banks offer the services of executorship for the wills made by their customers.

1.11 LET US SUM UP

The term 'Banking' has been comprehensively defined under BR Act. The banker is engaged in the business of accepting the deposits from the public and utilizing such deposits for lending or investment. The Act specifies the criteria to be fulfilled for being termed as 'Bank'.

The term 'customer' of a bank is not defined by law. Ordinarily, a person who has an account in a bank is considered as a customer. For the purpose of KYC policy, a 'Customer' is defined as a person or entity that maintains an account and/or has a business relationship with the bank.

Banks are also authorised to carry out other transactions as provided under Sec. 6 of BR Act. These services provided by banks to customers give rise to certain relationship between them. The general view is that the banker's relationship with the depositor is that of a debtor and a creditor. Other relationships are of: creditor - debtor, bailee - bailor, and trustee - beneficiary.

Deposits are either demand deposits or time deposits. Demand deposits are made up of current accounts and saving accounts, while time deposits include fixed deposits, short-term deposits, recurring deposits, MIDS/QIDS/reinvestment deposits, etc.

Other services provided by banks are merchant banking, lease financing, plastic money like credit or debit cards, etc.

Remittance services have been a major activity of banks since their inception. New-age remittance products are NEFT, RTGS, IMPS, and AEPS that are available on 24 x 7 basis.

Banks also administer and manage accounts under certain Government Schemes, especially those under Small Savings Schemes.

Banks also support Central Government measures to mobilise stock of gold with public through various schemes.

Banks are offering third party financial products like insurance products, mutual funds, stock trading account, demat account, and three-in-one accounts.

Banks also offer safe custody services and safe deposit vaults for safekeeping of valuable articles and documents. Banks also act as escrow agent (for funds and documents), trustee for assets, executors for estate.

1.12 KEYWORDS

Creditor, Debtor, Bailor, Bailee, Lessor, Lessee, Trustee, Principal, Indemnifier, Indemnified, Demand Deposits, Time Deposits, Hybrid Deposits, Tax Deduction at Source (TDS), Recurring Deposits, Merchant Banking, Initial Public Offering (IPO), Public Issue, Underwriting, Listing of Shares, Lease Financing, Credit Card, Debit Card, ATM Card, Pre-paid card, NEFT, RTGS, IMPS, AePS, NPS, SCSS, Gold Monetisation Scheme , Sovereign Gold Bond, Three-in-one account.

1.13 CHECK YOUR PROGRESS

1. Principal function(s) of banks is/are ________.
   (a) accepting deposits
   (b) lending and investing
   (c) non-fund business and remittance services
   (d) all of above (a) to (c)
   (e) only (a) and (b).
2. When a bank lends money to the corporate person the relationship between them is of ________.
   (a) borrower and lender
   (b) creditor-debtor
   (c) debtor-creditor
   (d) customer and client
3. What relationship is created when the bank collects a cheque in clearing?
   (a) holder for value
   (b) clearing member and principal
   (c) agent and principal
   (d) collecting bank and holder
   (e) none of above
4. Demand deposits are those which can be withdrawn ________.
   (a) on request
   (b) on sanction by Manager
   (c) on demand
   (d) on persuasion
5. Merchant bankers are ________.
   (a) financial brokers
   (b) financial intermediaries
   (c) credit appraisers
   (d) underwriters
   (e) All of the above.

1.14 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), **2.** (b), **3.** (c), **4.** (c), **5.** (b).

(Sources: Banking Regulation Act, RBI Circulars, Websites of various banks and NPCI)

UNIT 2

AML-KYC GUIDELINES

STRUCTURE

2.0 OBJECTIVES

After studying this Unit, you will:

- Understand the 'Money Laundering' and 'Financing of Terrorism' concepts
- Know about the purpose of KYC Policy and its elements
- Know about the obligations of banks under the Prevention of Money Laundering Act

2.1 MONEY LAUNDERING & FINANCING OF TERRORISM RISKS

2.1.1 Introduction

Money laundering (ML) is a process whereby the origin of funds generated from criminal activities (drug trafficking, gun smuggling, corruption etc.) is concealed and these funds are infused in the financial system appearing as if these originated from legitimate sources. Often such funds are deployed in legal activities or in legitimate assets.

Corruption, tax evasion, Ponzi schemes, other financial crimes, cybercrimes are closely connected with money laundering. Funds from these crimes now form a substantial portion of money laundering funds. Financial crimes (FC) now constitute a significant part of criminal activities.

Third component of the triad today is Terrorist financing (TF). With growth of several terrorist organisations, big and small, Terrorist financing has assumed large proportions. Terrorist financing has developed linkages with money laundering as for both purposes similar modalities are used.

Thus ML, TF and FC are interconnected. Another aspect is that certain criminals have organized into Organised Crime Groups (OCGs) and Professional Money Launderers (PMLs). OCGs and PMLs together form the network that propagates criminal activities and launders the funds generated from such activities.

Financial Action Task Force (FATF), a global organization, was set up for evolving measures to be taken by financial sector businesses and certain non-financial businesses and professions for prevention of money laundering. FATF issued certain recommendations that serve as anti-money laundering (AML) and combating financing of terrorism (CFT), and are known as FATF Standards 2012. Money laundering and terrorism financing are considered as criminal activities across the world.

2.1.2 Stages of Money Laundering

Funds from criminal activities are typically generated outside the financial system, and are placed in it to give them legal form. This money laundering cycle comprises three stages stated below.

(a) *Placement:* In this stage the funds from criminal activity are introduced into the financial system. Typically, this is done through deposits in multiple bank accounts.
(b) *Layering:* Next, those funds are passed through numerous financial transactions in these accounts creating several layers of funds transfers. This helps in hiding the source of these funds.
(c) *Integration:* Next step is collecting the funds lying in multiple accounts in one or few accounts that are then deployed for investing in some legal business activity or for acquiring some asset in legitimate manner.

2.1.3 Stages of Financing of Terrorism

There are numerous terrorist outfits, in the world. These have financial cycles similar to commercial entities, and use banks and financial institutions. Financing of Terrorism comprises following stages:

(a) *Raising:* Terrorist organisations source funds from their sympathisers both individuals and organisations. Sometimes, terrorist outfits also engage in various income generating activities, legal or criminal. Channeling funds from both such sources is done in a clandestine manner so that the purpose for which these are collected is not known.
(b) *Moving:* Contributors to the terrorist organisations can be located anywhere not only in their home country but across the world. These funds are therefore required to be moved to the places of their establishments of the terrorist organisations.
(c) *Storing:* As the funds raised may be deployed for terrorism related activities including the regular activities for running the outfits with a gap of time and spread over a period, these are parked in the interim in bank accounts or any other financial investment.
(d) *Using:* Finally, the raised funds are used for the purposes of carrying out the terrorism act or for various organisational related activities.

2.1.4 Objectives of Prevention of Money Laundering

The main objectives of measures for prevention of money laundering are:

(a) To prevent criminal elements from using the financial system for money laundering activities.
(b) To prevent spread of criminal activities in society.
(c) To safeguard the economy from financial crimes.
(d) To prevent terrorists from gaining access to financial resources.

2.2 AML FRAMEWORK IN INDIA

Based on FATF Recommendations, in India Prevention of Money Laundering Act, 2002 (PMLA) was enacted under which, inter alia, few obligations for all financial sector players and certain non-finance businesses have also been stipulated. These entities in the financial sector and the designated businesses in non-financial sector are termed as Reporting Entities (RE). Detailed legal provisions for REs, have been included in Prevention of Money Laundering (Maintenance of Records) Rules (PMLR).

Besides, specific institutional framework has also been put in place for dealing with money laundering crime.

(i) Financial Intelligence Unit-India (FIU-Ind) has been set up for receiving information about various financial transactions from certain businesses, including banks and financial institutions. FIU-India also has supervisory powers over the business entities that are subject to PMLA.
(ii) Enforcement Directorate (ED) is the investigation and prosecuting authority for money laundering crime. The powers of ED include tracking and attaching assets related to money laundering.
(iii) Special Courts are set up for adjudication of cases pertaining to money laundering crime. The adjudicating authority has powers to freeze the assets and even confiscate the assets proved to be related to money laundering.
(iv) The Regulators of various business activities, covered under PMLA, issue operating instructions and guidelines for the businesses regulated by them for discharging their obligations under the PMLA and PMLR.

2.2.1 Money Laundering Offence

The offence of money laundering has been defined in Sec. 3 of the PMLA as:

> "*whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money laundering*."

Sec. 45 of PMLA stipulates that all offences under the PMLA are to be deemed to be cognizable and non-bailable offences.

Sec. 4 of PMLA stipulates the punishment for money laundering offence, which is rigorous imprisonment for not less than 3 years but up to 7 years and fine as per the gravity of the offence. In cases connected with offences under the Narcotics Drugs and Psychotropic Substances Act the imprisonment may extend up to maximum 10 years.

2.2.2 Money Laundering – Risk Perception

Financial products and services are designed to provide quick, convenient and efficient modes for dealing with funds for different purposes. These are abused by the criminals for money laundering and financing of terrorism, by disguising or misrepresenting their true identities, profiles and purposes.

For example, for a salaried executive a savings account is a basic banking product that is used by her for managing her regular inflows and outflows of funds related to her livelihood and living needs. A criminal engaged in running a gambling racket, on the other hand, opens a savings account for dealing with betting money received from the customers. However, the criminal poses as a freelancer photographer to disguise the inflows as earnings from this occupation.

Thus the primary source of ML/FT risks is the customers. These are also affected by:

(i) Nature of products and services
(ii) Country of incorporation of the bank
(iii) Place of the bank branch
(iv) Place(s) with which the transaction is connected.
(v) Nature and value of transaction

2.2.3 Measures to Mitigate Money Laundering Risk

The obligations under PMLA require the banks to mitigate ML/FT risks. Banks are required to take appropriate measures for the following purposes:

(a) To know/understand the customers and their financial dealings better.
(b) To detect and report suspicious activities to FIU-Ind as per the laid down procedures.
(c) To comply with applicable laws and regulatory guidelines.
(d) To adequately train the staff in KYC/AML procedures.

These make it difficult for criminals to abuse banks for ML/FT as their activities are closely monitored. They mitigate ML/FT risks as criminals would avoid vigilant banks.

2.3 KNOW YOUR CUSTOMER POLICY

2.3.1 Practice of *Introduction*

Prior to the introduction of "Know Your Customer (KYC)" guidelines by the RBI in 2002, the banking practice was to obtain introduction for a new customer from an existing account holder of satisfactory standing and for certain period or from a staff member who knows the customer properly. The purpose of this practice was for getting protection provided under the Negotiable Instruments Act to a collecting banker. After RBI guidelines on KYC the banks have been advised not to obtain introduction.

Every bank is required to have a KYC Policy laying down the KYC/ AML norms.

2.3.2 'Customer' Definition: KYC Norms

Sec. 2(ha) of the PMLA defines customer as 'client' as follows:

> '"*client" means a person who is engaged in a financial transaction or activity with a reporting entity and includes a person on whose behalf the person who engaged in the transaction or activity, is acting*;'

This definition has been adopted by RBI in Master Direction - Know Your Customer (KYC) Direction, 2016 for defining 'Customer'.

A 'customer' from KYC norms perspective differs in from the traditional meaning of 'customer':

(i) It includes not just the person in whose name the dealings are carried out with the bank, but also those who actually act for such person.
(ii) It covers not only the account holders and those having continued relationship, but also those who avail of any service on one-off basis.

For the purpose of KYC requirements, a bank needs to include a wide range of persons availing various services, like:

- A bank account including fixed deposits
- Credit facilities (fund-based or non-fund based)
- Remittance facility on stand-alone basis even once or multiple times
- Demat account (Bank is a Depository Participant)
- PPF account or Pension Fund account
- Third party product (e.g. insurance, mutual fund)
- Safe custody services or safe deposit locker services
- Receiving remittances for payouts

Besides, the following persons are also considered 'customer':

- In case of entities availing services – their beneficial owners
- In case of accounts maintained by Professional Intermediaries for their clients – beneficiaries of the transactions

2.3.3 Key Elements of Know Your Customer (KYC) Policy

KYC Policy is a major policy for managing a bank in prudent and compliant manner mitigating ML/TF risks effectively and efficiently. Key requirements for KYC Policy are:

(i) It is to be approved by the Board of Directors or any committee of the Board (if delegated).

(ii) It should be reviewed regularly, at least once in a year, besides based on any event impacting it, viz. changes in PMLA/ PMLR/ Regulations of RBI, etc., entering new business line, entering a new jurisdiction, etc.
(iii) Usually, the Principal Officer is responsible for keeping the KYC Policy updated and relevant.

KYC Policy is a comprehensive document that contains norms related to handling of the customer's business, organization set-up for various responsibilities, creating awareness among customers and staff. The key elements of KYC Policy are:

(a) Customer Acceptance Policy,
(b) Customer Identification Procedures,
(c) Risk Management, and
(d) Monitoring of Transactions.

Some banks may have two distinct documents covering KYC Policy (pertaining to Customer Identification and Customer Due Diligence) and AML/CFT Policy (pertaining to Monitoring of Transactions and Reporting to FIU).

2.4 ORGANISATIONAL SET-UP FOR AML

PMLR stipulate that banks must designate following functionaries for meeting PMLA obligations:

(a) Designated Director, and
(b) Principal Officer.

Besides, each bank has a distinct function to discharge responsibilities of monitoring and reporting under PMLA. Other functional units have to discharge respective functions pertaining to KYC/AML obligations.

(a) *Designated Director*:

A Designated Director (DD) is responsible for overall compliance with the obligations of the bank as spelt out in the PMLA (Sec. 11A, 12, 12A and 12AA), PMLR and the regulatory guidelines of regulators concerned . DD shall be a functionary, who is:

i) the Managing Director or a whole-time Director, duly authorized by the Board of Directors, if the RE is a company.
ii) the Managing Partner, if the RE is a partnership firm.
iii) the Proprietor, if the RE is a proprietorship concern.
iv) the Managing Trustee, if the RE is a trust.
v) a person or individual, as the case may be, who controls and manages the affairs of the RE, if the RE is an unincorporated association or a body of individuals.
vi) a person who holds the position of senior management or equivalent designated as a 'Designated Director' in respect of Cooperative Banks and Regional Rural Banks.

DD is responsible to ensure that the bank:

(i) Has appropriate functional set-up, systems and processes for KYC/ AML requirements.
(ii) Keeps the KYC Policy duly updated.
(iii) Has skilled staff at all levels.
(iv) Takes suitable measures with changing complexion of ML/TF risks.

(b) *Principal Officer (Money Laundering Reporting Officer) (PO)*:
Banks must designate a senior officer as Principal Officer in terms of PMLA. The main functions of PO are as follows:
(i) Monitoring implementation of the bank's KYC/AML Policy.
(ii) Reporting of Transactions to and sharing of information with FIU-Ind.
(iii) Maintaining liaison with law enforcement agencies.
(iv) Ensuring submission of periodical reports to the top Management/Board.
(v) Keeping the AML monitoring systems updated.

(c) *AML Team*:
A distinct functional unit is put in place for taking necessary measures for compliance with legal and regulatory AML and CFT stipulations. The main functions of this unit are:
(i) To review and update KYC Policy regularly
(ii) To guide the business/ operations functions in respect of customer identification/ due diligence
(iii) To undertake ML/TF risk assessment of the bank and review it periodically
(iv) To assist business/ operations units in customer risk categorisation
(v) To monitor transactions for detection of suspicious transactions
(vi) To submit various prescribed reports and any information sought to FIU-India

2.5 OBLIGATIONS UNDER PMLA

PMLA lays down the following primary obligations for RE's, including banks:

(i) To verify the identity of customers and their beneficial owners through any of the specified modes. These include authentication/ offline verification of Aadhaar, or passport, or any of the specified officially valid documents.

(ii) To maintain records of all transactions as specified, furnish the information of prescribed transactions, including attempted transactions. These records shall be kept for a period of 5 years from the date of transaction.

(iii) To maintain records of identity documents (of clients and beneficial owners), and account files and business correspondence of clients. These are to be maintained for a period of 5 years from the date of closure of accounts or end of relationship, whichever is later.

(iv) Keep all information maintained and furnished confidential.

(v) Before commencement of the specified transactions, bank shall carry out the following:
- verify the identity of clients by Aadhaar authentication or any other prescribed mode,
- examined ownership, financial position and sources of funds of the customer, and
- record the purpose behind the transaction and nature of relationship between the transaction parties.

The specified transactions are cash withdrawals/ deposits and foreign exchange transactions above specified threshold value, high value imports and remittances, and other transactions of ML/TF risk and in the interest of revenue.

(vi) Not to carry out any specified transaction if unable to take the aforesaid measures.

(vii) If any of such transactions are considered suspicious, the business relationship should be put under enhanced monitoring, with greater scrutiny of such transactions.

2.6 RISK MANAGEMENT

(a) ***Risk Based Approach***

Banks shall apply a Risk Based Approach (RBA) for mitigation and management of the identified risk and should have Board approved policies, controls and procedures in this regard. They shall monitor the implementation of the controls and enhance them if necessary.

The objective is to adopt customer due diligence and transaction monitoring measures depending on the risk levels, so that the AML/CFT measures are effectively implemented.

(b) ***Risk Assessment***

Banks should undertake assessment of and take effective measures to mitigate the ML/TF risks from customers, products/ services, regions/ countries where its offices are located, delivery channels, and the transactions undertaken by their customers.

This exercise should be proportionate to the nature, size, geographical presence, complexity of activities/ structure, etc. of the bank, and should be done at least annually.

(c) ***Customer Risk Categorisation***

Customers are classified into three risk categories namely high, medium and low, based on the risk perception of the bank. Parameters of risk perception are clearly defined in terms of the nature of business activity, location of customer and his clients, mode of payments, volume of turnover, social and financial status etc. to enable categorization of customers into low, medium and high risk; customers requiring very high level of monitoring, e.g. Politically Exposed Persons may, if considered necessary, be categorised even higher.

Individuals (other than High Net Worth Individuals) and entities whose identities and sources of wealth can be easily identified and transactions in whose accounts by and large conform to the known profile may be categorized as low risk. Customers who are likely to pose a higher than average risk to the bank should be categorized as medium or high risk. These could be customers engaged in cash intensive businesses with high turnover, say jewellers, petrol pumps, etc.

Review of risk categorisation of customers is carried out at least every six months, based on the transactions carried out by the customer. Besides, risk category may be reviewed whenever any additional information of the customer comes to knowledge or any change in conduct of business noticed.

(d) ***Role of Other Functions***

For effective risk management, an appropriate framework covering proper management oversight, systems, controls and other related matters is required.

The bank's internal audit team undertakes independent evaluation of the compliance with KYC/ AML Policy, including legal and regulatory requirements. Concurrent/ internal auditors shall specifically check and verify the application of KYC/AML procedures at the branches. The findings and compliance in this regard will be placed before the Audit Committee of the Board at quarterly intervals.

(e) ***Introduction of New Technologies***

Continuing development of Information and Communication Technology leads to new technology based products, like Smart Cards/Mobile Wallet/ Net Banking/ Mobile Banking/RTGS/ NEFT/IMPS etc. They have different and often new features that may pose new ML/FT risks. Banks should build in appropriate KYC procedures before introducing new products/services/technologies.

(f) ***Staff Hiring and Training***

Bank staff, are potentially of high inherent risk by virtue of their access to the bank's systems, their role in conducting the bank's business and the powers exercised by them. Hence, banks should have adequate screening mechanism as a part of their recruitment process.

Banks should also carry out due diligence and KYC in respect of third parties used for business activities, like Business Correspondents, Direct Sales Agents, Recovery Agents,, etc.

Banks should equip its audit function with persons adequately trained and well-versed in AML/CFT policies, regulations and related issues.

All employees need to be appropriately trained in KYC/AML procedures and sensitized about the significance of ML/FT risks. The training programs should be role-based for creating better understanding among the staff about their own responsibilities in this regard. Ongoing training is required to keep staff updated with the latest regulatory norms and the emerging modalities adopted by criminals.

2.7 OBLIGATIONS UNDER INTERNATIONAL AGREEMENTS

Banks are not permitted to open or maintain accounts of the individuals/ entities that appear in the following two lists, of individuals/ entities suspected to have terrorist links, circulated and periodically updated by the United Nations Security Council (UNSC):

(i) The "ISIL (Da'esh) &Al-Qaida Sanctions List", which includes names of individuals and entities associated with the Al-Qaida.

(ii) The "1988 Sanctions List", consisting of individuals (Section A of the consolidated list) and entities (Section B) associated with the Taliban.

Following measures are required to be taken if any match is found with any of the listed individuals/ entities:

(i) To advise FIU-IND and Ministry of Home Affairs details of such accounts as per UAPA notification dated 2nd February, 2021.

(ii) To follow the procedure of freezing of assets of such individuals/ entities with the order of the Ministry of Home Affairs, in accordance with the procedure laid down in the aforesaid Notification.

Any other Resolution of UNSCR circulated by RBI shall also be taken note of by the banks.

2.8 FATF IDENTIFIED JURISDICTIONS

FATF issues Statements of countries that do not or insufficiently apply the FATF Recommendations, once in every four months. Banks should take into account risks arising from the deficiencies in AML/ CFT regime of the jurisdictions included in the FATF Statement. Specifically following measures need to be taken:

(i) Special attention shall be given to business relationships and transactions with persons (including legal persons and other financial institutions) from or in these countries. However, banks are not prohibited from having legitimate trade and business transactions with these countries.

(ii) The background and purpose of transactions with persons (including legal persons and other financial institutions) from these countries should be examined, and written findings together with all documents should be retained and should be made available to RBI/other relevant authorities, on request.

2.9 CORRESPONDENT BANKS

Correspondent banking can be defined, in general terms as an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks. Correspondent banking is the lifeline of global financial transactions and hence crucial for international trade, travel and tourism. At the same time it also has inherent in its activity and nature risk of abuse by criminals for money laundering and terrorism financing. Due to different level and nature of AML/ CFT regimes in various countries correspondent banks are exposed to the ML/FT risks to each other. Banks are therefore required to follow certain norms in establishing and maintaining 'correspondent relationships'.

(i) Banks should have a Policy for establishing correspondent relationships.
(ii) The Policy should spell out the conditions for establishing such relationships.
(iii) Due Diligence of the correspondent banks should include information on the nature of business of the bank, management, major business activities, level of AML/CFT compliance, purpose of opening the account, identity of any third party entities that will use the correspondent banking services, and regulatory/supervisory framework in the bank's home country.
(iv) No correspondent relationship should be established with a shell bank. Also, to ensure that the respondent bank do not allow the account to be used by shell banks.
(v) Banks shall be cautious with correspondent banks located in jurisdictions which have strategic deficiencies or have not made sufficient progress in implementation of FATF Recommendations.

2.10 REPORTING UNDER FATCA/CRS

The Foreign Account Tax Compliance Act (FATCA) is tax information reporting regime, which requires Financial Institutions (FIs) to identify their U.S. accounts through enhanced due diligence reviews and report them periodically to the U.S. Internal Revenue Service (IRS) or in case of Inter-Governmental agreement(IGA), to appropriate government authority. The purpose of FATCA is to prevent U.S. persons from using banks and other financial institutions outside the USA to park their wealth outside U.S. and consequently avoid U.S. taxation on income generated from such wealth. In pursuance of Foreign Account Tax Compliance Act (FATCA) of the USA, and Common Reporting Standards (CRS) of OECD Council, in response to G20 request, Income Tax Rules 114F, 114G, and 114 H have been put in place that require banks and financial institutions to declare if they are a Reporting Financial Institution, in terms of these Rules.

These Rules require banks and financial institutions to submit prescribed reports to the Income Tax Dept. in respect of the accounts of such customers who are taxable in the USA (for FATCA) and any other foreign country (for CRS).

2.11 REPORTING OBLIGATIONS

Banks are required to furnish to FIU-IND reports pertaining to transactions of prescribed type and value at prescribed frequency.

(a) ***Monthly Reports***

Following four reports are required to be submitted for each calendar month by the 15thof the following month.

S.No.	Report	Nature of Transactions
1	Cash Transactions Report (CTR)	(a) Cash transactions of ₹10 lakh or more or equivalent (b) Series of cash transactions in a month integrally connected to each other (i.e. all deposits or all withdrawals taken separately) aggregating ₹10 lakh or more or equivalent
2	Cross Border Wire Transfer Report (CBWTR)	Cross border wire transfers of more than ₹5 lakh or equivalent where either the origin or destination of fund is in India
3	Non-Profit Organisation Report (NTR)	Receipts by non-profit organisations of more than ₹10 lakh or equivalent
4	Counterfeit Currency Report (CCR)	All counterfeit currency notes received

(b) ***Suspicious Transactions Report (STR)***

Banks are required to report to FIU-IND any suspicious transaction noticed by them, within 7 days of establishing suspicion. This is the key report for FIU-IND to enable it to provide useful intelligence to the law enforcement agencies. A transaction is considered as suspicious if to a person acting in good faith, it appears to satisfy any of the following:

(i) A reasonable doubt that it may involve proceeds of an offence specified in the Schedule to PMLA, i.e. likely to be for money laundering.
(ii) Appears to be made in circumstances of unusual or unjustified complexity.
(iii) Appears to have no economic rationale or bonafide purpose.
(iv) A reasonable doubt that it may involve financing of the activities relating to terrorism.

For reporting suspicious transactions the value of transactions is not relevant. Even non-monetary transactions are to be reported, for instance unusual operations of the locker. Even attempted transactions are to be reported, for example a customer not proceeding with opening an account on being asked for certain documents or information.

2.12 IMPLICATIONS OF NON-COMPLIANCE OF PMLA OBLIGATIONS

Banks face risk of penal actions by RBI and Director, FIU-IND for non-compliance with obligations cast on them under PMLA and PMLR.

PMLA has empowered the Director, FIU to take any of the following punitive measures, against a bank, any of its employees, managers, or directors:

(i) Issue a written warning.
(ii) Direct to take specific remedial measures and to submit the action taken report on these.
(iii) Impose monetary penalty with a minimum of ₹10,000/- to maximum of ₹1 lakh per violation.

Each day of delay in submission of some information or a transaction or a report or in rectification of information/ report is reckoned as one violation.

2.13 SECRECY OBLIGATIONS

Banks are required to maintain secrecy regarding the information obtained from the customer that arises from contractual obligations. Details of customer information shall not be divulged for the purpose of cross selling, or for any other purpose without the express permission of the customer. Also, when responding to the requests for data/information from Government and other agencies, banks shall satisfy themselves that the information being sought is not of such a nature as will violate the provisions of the laws relating to secrecy in the banking transactions.

There are a few exceptions to this basic rule:

(i) Where disclosure is under compulsion of law
(ii) Where there is a duty to the public to disclose,
(iii) The interest of bank requires disclosure, and
(iv) Where the disclosure is made with the express or implied consent of the customer.

2.14 LET US SUM UP

Banks are exposed to abuse of their services by criminals for the purpose of Money Laundering, Financing of Terrorism, and Financial Crimes. The criminals have organised themselves in groups engaged in criminal activities (Organised Criminal Groups) and those engaged in money laundering (Professional Money Laundering Groups). In India, PMLA pertains to money laundering crime. UAPA has been amended to cover terrorism and terrorism financing crimes.

FIU-Ind has been set up for collecting, analyzing and disseminating information about suspicious financial transactions to the law enforcement agencies. ED is responsible for investigation and prosecution of criminals, and Special Courts adjudicate on the money laundering related cases.

All financial sector businesses and certain non-financial sector businesses are required to comply with the obligations under PMLA. These pertain to customer identification, due diligence, reporting of specified transactions (including suspicious transactions) to FIU-Ind, and maintaining records.

The reports to FIU-Ind are Cash Transaction Reports(CTR), Cross Border Wire Transfer Report (CBWTR), Non-Profit Organisation Transaction Report (NTR), Counterfeit Currency Report (CCR), and Suspicious Transactions Report (STR).

Banks need to assess at least once a year ML/FT risks from various sources, undertake risk categorisation of customers, products/ services, delivery channels, regions/ countries of operations and transactions handled, and adopt risk based approach in both customer due diligence and transaction monitoring.

Banks need to exercise appropriate diligence in handling transactions or customers connected with FATF identified high risk and weak countries. Banks also need to conduct adequate due diligence when providing or availing correspondent banking services with banks in other countries.

2.15 KEYWORDS

Money Laundering, Financing of Terrorism, Designated Director, Principal Officer, Officially Valid Document, Customer Due Diligence, Know Your Customer, Suspicious Transaction, Money Laundering Offence, FATCA, CRS, Financial Intelligence Unit-India.

2.16 CHECK YOUR PROGRESS

1. Objective(s) of KYC is/ are ______.
   (a) to ensure appropriate customer identification
   (b) to monitor transactions of suspicious nature
   (c) to ensure that the customer would not deceive the bank.
   (d) to ensure if loan is given it would not become a NPA
   (e) Only (a) and (b)
2. Banks appoint a _____ who is responsible for submission of reports to FIU-Ind.
   (a) Designated Director
   (b) Company Secretary
   (c) Principal Officer
   (d) Compliance Officer
3. Customers are typically categorized in ______ risk categories.
   (a) four
   (b) three
   (c) two
   (d) five
4. Director, FIU-India can take action against _____ for violation of PMLA obligations.
   (a) the bank
   (b) any employee
   (c) the Principal Officer
   (d) all of the above
5. Non Profit Organisations Transactions Report pertains to______ in the accounts of NPOs.
   (a) cash transactions
   (b) all transactions
   (c) receipts above a threshold value
   (d) cash receipts

2.17 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (e), **2.** (c), **3.** (b), **4.** (d), **5.** (c).

(*Sources: Various literature on AML,PMLA and PMLR, KYC Direction, Website of FATF, Website of FIU.*),

UNIT 3

OPERATIONAL ASPECTS OF KYC

STRUCTURE

3.0 OBJECTIVES

After studying this Unit, you will:

- Understand KYC requirements for various types of customers
- Know the requirements for using Aadhaar
- Learn the CKYCR requirements
- Know the periodical updation modalities

3.1 INTRODUCTION

PMLA and PMLR lay down the legal requirements for measures to be taken by various types of Reporting Entities stipulated under PMLA. RBI has laid down certain operational norms for banks and other entities regulated by it, in Master Directions – 'Know Your Customer (KYC) Directions 2016.

The provisions of these Directions also apply to the branches and majority owned subsidiaries located abroad, to the extent they are not contradictory to the local laws in the host country. In case there is a variance in KYC/AML standards prescribed by the RBI and the host country regulators, branches/ subsidiaries of banks are required to adopt the more stringent regulation of the two. Branches/subsidiaries in India of foreign incorporated banks may adopt the more stringent regulation of the two i.e. standards prescribed by the RBI and their home country regulators.

3.2 KNOW YOUR CUSTOMERS (KYC) NORMS

RBI instructions cover the requirements for customer acceptance and customer identification.

3.2.1 Customer Acceptance Policy

The customer acceptance policy of a bank lays down the criteria for accepting a customer from the perspective of ML/TF risks. Customer acceptance policy should include the following norms:

(a) No account is opened in anonymous or fictitious/benami name.
(b) No account is opened where appropriate customer due diligence measures cannot be applied either due to non-cooperation of the customer or non-reliability of the documents/information furnished by the customer.
(c) No transaction or account-based relationship is undertaken without following the CDD procedure.
(d) Circumstances in which, a customer is permitted to act on behalf of another person/entity, is clearly spelt out.
(e) To ensure that the identity of the customer does not match with any person or entity, whose name appears in the sanction lists circulated by RBI.
(f) To verify Permanent Account Number (PAN) obtained through the facility of the issuing authority.
(g) To verify the digital signature of an e-document given by the customer,
(h) The mandatory information to be obtained for KYC purpose during on-boarding/ periodic updation should be specified in the KYC Policy. Any optional/ additional information should be obtained with prior consent of the customer, and after the account is opened.
(i) In case of joint accounts, CDD procedure is to be carried out for all joint account holders.

Customer Acceptance Policy should not result in denial of banking/financial facility to members of the general public, especially those, who are financially or socially disadvantaged.

In case of non-compliance of the KYC guidelines by an existing customer, banks may decide to close the account after giving due notice to the customer.

3.2.2 Customer Identification Procedures (CIP)

Customer identification includes identifying and verifying the identity by using reliable, independent source documents, data or information. Customer identification is required to be done in following cases:

(i) While opening an account or establishing account based relationship.
(ii) Undertaking international transfer for non-account holders.
(iii) If a doubt arises about authenticity of an existing customer or adequacy or correctness of information about the customer.
(iv) Selling any product including third party products, loading/ reloading of prepaid/ travel cards for value of over Rs.50,000/-.
(v) Carrying out a transaction or series of connected transactions valuing over Rs.50,000/- for a walk-in-customer.
(vi) When there is a doubt that a customer (account based or walk-in) is intentionally structuring transactions below the threshold of Rs.50,000/-.

While establishing customer identity verification of documents with the issuing authority, through any mode provided by it, should also be factored in. If a bank relies on third party for customer identification process, it has to adopt suitable precautionary measures. The ultimate responsibility is on the bank onboarding the customer.

3.2.3 Customer Due Diligence Procedure

Customer due diligence includes customer identification, and also obtaining information about the customer's location, activity and purpose for which banking services will be used. Depending on the risk perceived from the customer, information on the nature or business activity, location, mode of payments, volume of turnover, social and financial status, etc., is collected for completing the profile of the customer. Let us look at the basic documentary requirements for various types of customer entities. Banks can ask for additional documents, if considered necessary.

3.2.3.1 For Individuals

(i) ***Individuals Requiring CDD***:

Documents to be obtained from an individual associated with the bank in any of the under mentioned capacities are listed here.

- A person entering in an account based relationship,
- A beneficial owner of a legal entity customer
- An authorised signatory of a legal entity customer
- A power of attorney holder of a legal entity customer

(ii) ***Documents requirements***:

(a) Aadhaar Number – if any benefit or subsidy from the Central Govt. is to be received in the account or the customer is voluntarily providing Aadhaar number, or

- A certified copy of any Officially Valid Document (OVD) containing details of identity and address or an equivalent e-document of any OVD. For certified copies, the original documents are to be verified, and self-certified copy duly authenticated by the officer of the bank stating 'verified with the original' is to be obtained.

- In case of Non-Resident Indians or Persons of Indian Origin a copy of the document certified by any of the specified authorities as listed below should be obtained, in original:

Authorised officials of overseas branches of scheduled commercial banks registered in India; Branches of overseas banks with whom Indian banks have relationships; Notary Public abroad; Court Magistrate; Judge; Indian Embassy/Consulate General in the country where the non-resident customer

- For e-document, digital signature is to be verified,

(b) One recent photograph where an equivalent e-document is not submitted,

(c) Permanent Account Number or Form No. 60 as defined in Income-tax Rules, 1962, or its equivalent e-document, and

(d) Such other documents including in respect of the nature of business and financial status of the customer, or the equivalent e-documents thereof as may be required by the RE

(iii) ***Officially Valid Documents***:

Following documents have been notified as OVDs for KYC purposes:

i) Passport;
ii) Driving Licence;
iii) Proof of possession of Aadhaar number;
iv) Voter's Identity Card issued by the Election Commission of India;
v) Job card issued by NREGA duly signed by an officer of the State Government; and
vi) Letter issued by the National Population Register (NPR) containing details of name and address.

(iv) ***Updated Address***:

In case any of the aforesaid documents does not have updated address of a customer, for the limited purpose of address following are considered as OVD:

i) Utility bill which is not more than two months old of any service provider (electricity, telephone, post-paid mobile phone, piped gas, water bill);
ii) Property or Municipal tax receipt;
iii) Pension or family pension payment orders (PPOs) issued to retired employees by Government Departments or Public Sector Undertakings, if they contain the address; and
iv) Letter of allotment of accommodation from employer issued by State Government or Central Government Departments, statutory or regulatory bodies, public sector undertakings, scheduled commercial banks, financial institutions and listed companies and leave and licence agreements with such employers allotting official accommodation.

Where any of the above mentioned documents is obtained for address purpose, within three months an OVD with current address must be submitted by the customer.

In case of a foreign national where the OVD does not contain address, a document issued by a Government department of the foreign jurisdiction containing address and a letter issued by the Foreign Embassy or Mission in India shall be accepted as proof of address.

(v) ***Change in name***:

Where there has been a change in name, an OVD with previous name along with the marriage certificate or the Gazette Notification indicating the change in name can be accepted.

(vi) ***Aadhaar Based KYC***:

A. Norms for use of Aadhaar

Following norms are applicable where Aadhaar number is used for KYC purposes:

(a) To be used only with the written consent of the customer.
(b) Must be redacted on the bank's records, physical and electronic, retaining only the last 4 digits.
(c) A customer wanting credit of benefit/ subsidy under a notified scheme: Biometric authentication of Aadhaar is mandatory. Under this method demographic details and photograph are provided by the UIDAI. If due to illness, injury, etc. biometric authentication is not feasible then offline-verification of Aadhaar number or a certified copy of any OVD may be obtained. The reasons and the name of the official permitting should be recorded, and subjected to concurrent audit.
(d) For a customer voluntarily using Aadhaar number for identification purpose: banks may carry out e-KYC Authentication or offline verification. Other financial institutions can also use e-KYC authentication, if authorised.
(e) If a customer provides a current address different from that in Aadhaar records, a self-declaration is to be obtained.

B. Accounts of non-face-to-face customers - OTP based Aadhaar Verification

Restrictions for accounts of non-face-to-face customer with OTP based e-KYC of Aadhaar:

i) aggregate balance of all the deposit accounts of the customer shall not exceed ₹1 lakh (on exceeding the threshold, the account to be made non-operational till submission of an OVD);
ii) the aggregate of all credits in a financial year, in all the deposit accounts taken together, shall not exceed ₹2 lakh;
iii) for borrowal accounts, only term loans shall be sanctioned and the aggregate amount of term loans sanctioned shall not exceed ₹60,000/- in a year;
iv) both deposit and borrowal accounts shall not be allowed for more than one year within which normal mode identification is to be done;
v) if OVD is not submitted/ CDD procedure not completed within a year, a deposit account will be closed and no disbursals will be made on the borrowal account; and
vi) a declaration to be obtained that no other account using this mode has been opened nor will be opened at any other financial institution or a bank.

3.2.3.2 For Sole Proprietary Firms

CDD of the individual (proprietor) shall be carried out and in addition, any two, of the following documents are to be obtained:

i) Registration certificate; ii) Certificate/licence issued by the municipal authorities under Shop and Establishment Act; iii) Sales and income tax returns; iv) CST/VAT/GST certificate (provisional/final); v) Certificate/registration document issued by Sales Tax/ Service Tax/Professional Tax authorities; vi) IEC (Importer Exporter Code) issued to the proprietary concern by the office of DGFT or Licence/certificate of practice issued in the name of the proprietary concern by any professional body incorporated under a statute; vii) Complete Income Tax Return (not just the acknowledgement) in the name of the sole proprietor where the firm's income is reflected, duly authenticated/acknowledged by the Income Tax authorities; viii) Utility bills such as electricity, water, landline telephone bills, etc.