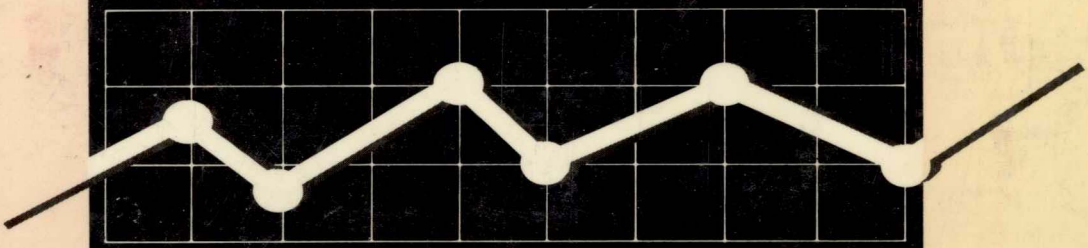
BANKING & FINANCE SERIES

THE PRACTICE OF BANKING

PART 1



M. MARSDEN

GRAHAM & TROTMAN

Banking and Finance Series

The Practice of Banking, Part 1

by

Michael Marsden
Bank of Credit and Commerce International, London

Graham & Trotman

First published in 1985 by

Graham & Trotman Limited
Sterling House
66 Wilton Road
London SW1V 1DE

Graham & Trotman Inc.
13 Park Avenue
Gaithersburg
MD 20877, USA

ISBN 0 86010 563 6 (softcover)
0 86010 580 6 (hardbook)

British Library Cataloguing in Publication Data

Marsden, Michael
The practice of banking.——(Banking and finance series)
Pt. 1
1. Banks and banking——Great Britain
I. Title II. Series
332.1'0941 HG2988

ISBN 0–86010–580–6
ISBN 0–86010–563–6 Pbk

Typeset in Great Britain by Castlefield Press, Northants

Printed and bound in Great Britain

Series Foreword

The *Banking and Finance Series* has been written for students who are preparing for the Associateship of the Institute of Bankers. The structure of the series follows the syllabus closely. Although the emphasis is on the Institute of Bankers' examinations the series is also relevant to students for the kinds of other professional examinations such as the different Accountancy Bodies, Chartered Secretaries, Diploma in Public Administration, undergraduate business course, B.T.E.C., B.E.C., H.N.D., D.M.S., Stock Exchange courses, Association of Corporate Treasurers, Institute of Freight Forwarders, Institute of Export.

July 1985

Brian Kettell
Series Editor

Preface

This book covers a broad range of topics relating to banking but aims primarily at the aspects of banking which comprise the syllabus of the Institute of Bankers examination in Practice of Banking — 1 (Banking Diploma — Stage 2). Although the textbook should be of particular interest and assistance to students engaging upon a study of the relative Institute of Bankers subject, the book will, due to the wide range of technical banking information it contains coupled with the practical guidance it affords, provide a useful general reference book for practising branch bankers and for students in educational institutes who are studying financial and business courses.

A separate publication of "Questions and Answers" has been produced in conjunction with this textbook which is structured similarly to the textbook, and which is cross-referenced to the relative section of the textbook. Those readers who are studying for the Institute examination should benefit from using that manual in conjunction with this book, particularly since it contains a considerable number of questions with specimen answers. The questions and answers in each chapter of the "Questions and Answers" manual involve topics covered in the corresponding chapters of this book, and thus the student reader is able to test his knowledge of the various banking topics as he goes along.

The Practice of Banking examinations for the Banking Diploma of the Institute of Bankers are practical ones and require candidates to identify the banking issues involved, set out the relevant principles and then, based upon an appreciation of these together with the application of common-sense, state what action is needed in the particular circumstances set out in a question.

The contents of this book should provide students with the knowledge they require for this type of examination question and the "Questions and Answers" manual referred to earlier, which is available as a separate

publication, gives students ample opportunity to practice their approach to such questions and then assess their efforts by reference to the specimen answers provided.

Michael Marsden
July 1985

Contents

Chapter 1

Banker and Customer Relationship

INTRODUCTION

There is no really adequate definition of the term "banker", neither is there a statutory definition of a "customer." Nevertheless it is important for a banker to know what constitutes a customer, especially bearing in mind the purposes of Section 4 of the Cheques Act 1957. The length of association is not now considered to be an essential feature, but the customer must have an account, although the intention to open an account may suffice. A series of isolated transactions carried out by a banker for a person (e.g. the collection of cheques for someone who has no account and the payment to the person of the proceeds after clearance) does not make that person a customer. A reasonable definition of a "customer" may therefore be: "a person who has an account or an account in contemplation", and where the banker has agreed to open an account if so requested. When someone walks into a bank and asks to open a banking account, he is making an offer to enter into a contract. When the banker agrees to open the account, he is legally accepting the offer and thus a binding contract is created. However, before committing himself, the banker will want to be satisfied that the person will be a suitable customer, either by personal introduction, by taking and following up references or making some form of enquiry (see later).

Before considering the nature of the relationship between banker and customer, it is perhaps useful to revert to the question of what a "banker" is in the light of the changes introduced into the system for regulating "banks" by the Banking Act of 1979.

THE BANKING ACT 1979

The United Kingdom has had a highly developed banking system for

centuries which, unlike the banking systems of most countries, was until recently not comprehensively regulated by statute. Regulation was nevertheless present, by way of the control exercised by the Bank of England by informal means, supported by the provisions of the Bank of England Act 1946. Other statute law has played a part in governing certain aspects and activities of banks and other financial institutions, e.g. the moneylenders Acts, the Protection of Depositors Act and the Consumer Credit Act.

Due to a variety of reasons (such as the growth of institutions on the fringe of the established banking system, and the fringe banking crisis which came about in 1974, the tremendous influx of overseas banks into the UK, the growth and development of newer and larger international capital markets with the added complication and sophistication these brought about) the task of domestic regulation became far more difficult than it had been when the banking system was less developed and less diverse. However, the factor primarily responsible for the Banking Act of 1979 was the UK's European Community obligations and the directive which required the UK to have an official licensing system for banks and similar financial institutions. Nevertheless, the need for a banking act had been recognised due to the awareness of the dangers of inadequate supervision of fringe institutions and the need to remove confusion on the part of the public as to what were and were not banks. The banks themselves were also, in general, probably receptive to the introduction of tighter controls; certainly the English and Scottish clearing banks would have seen and supported the need for some change, in the light of the extent to which they collectively had to safeguard the fabric of the UK banking scene, under the leadership of the Bank of England, by means of the "lifeboat" they provided to preserve confidence and underwrite public deposits when the fringe banking crisis emerged.

The Banking Act 1979 does not set out to control and regulate detailed aspects of banking. Its main purposes are:

(1) to stop any bank or financial organisation, whether existing or newly formed, accepting deposits without having obtained covering authority from the Bank of England;
(2) to lay down the criteria which it is necessary to satisfy in order to obtain and retain such authority;
(3) to provide a statutory framework within which the Bank of England will supervise the activities of all the relative institutions;
(4) to monitor and control banking names, with banking names being restricted largely to recognised banks (see later);
(5) to safeguard depositors' money in licensed institutions by way of a Depositors' Protection Scheme.

The Act brought in two types of authorisation for deposit taking institutions, these being:

(a) Recognised Bank; or
(b) Licensed Deposit Taker.

The requirements of the EEC banking directive did not contain such division and the two categories were devised by the Bank of England with the intention of limiting the use of banking names and descriptions and enabling close control to be exercised over licensed deposit takers, with the more informal measure of control being retained as far as recognised banks were concerned.

The Act came into operation in October 1979 and all relevant institutions had to apply by April 1980 to the Bank of England for recognition or a licence to enable them to continue accepting deposits thereafter. After that time, any new institution could not legally commence business to take deposits without first obtaining a licence to do so from the Bank of England.

Certain institutions which take deposits are specifically excluded from the requirements of the Banking Act. The Bank of England does not require a licence, neither do the National Savings Bank, the Trustee Savings Banks, the National Giro and local authorities. For one reason or another these institutions are all regarded as not being subject to the risks that prevail in the private sector. Although the building societies are huge takers of deposits, they are not, at present, governed by the Banking Act but by separate legislation, and they have for many years been under the control of the Chief Registrar of Friendly Societies.

Any institution seeking recognition or a licence will be required to satisfy the criteria laid down by the Act. The applicant will have to satisfy the Bank of England as to its solvency and also on the question of whether or not its management is competent and sufficiently experienced. Over and above this, an institution seeking recognised status has to provide a sufficiently wide range of banking services and must satisfy the Bank of England that it is of high standing and enjoys a good reputation in the financial community.

Under the terms of the Act, a recognised bank has to provide the following five services:

- the acceptance of deposits;
- granting loans and other credit facilities;
- foreign exchange dealing;
- bill finance and the handling of documents relating to overseas trade;
- corporate finance and investment management.

However, the Act grants discretion to the Bank of England to accept the absence of one or two of the last three services where it considers this appropriate, and the Bank of England can also award recognised status to institutions who may not provide these services in full but who demonstrate to the satisfaction of the Bank of England that they provide what in the Act is referred to as a "highly specialised banking service."

The Banking Act of 1979 has removed some uncertainties which may have

existed about the scope of the Bank of England's powers and has clarified where responsibility for banking supervision rests; whereas prior to its introduction there was an element of confusion caused by divided responsibilities on some aspects such as between the Bank of England and the Department of Trade. Additionally the Act has made redundant certain provisions which previously existed under sections of the Protection of Depositors Act and the Companies Acts.

The banking industry and the markets seem to have settled down with the Banking Act which has now been in operation for almost six years. Although the system of supervision has undergone change as a result of the legislation, with authorisation being derived from statute, the requirements of the Act nevertheless are part of a broader and balanced supervisory role performed by the Bank of England, which seems successful in achieving a good balance between the respective merits of statutory and non-statutory methods of supervision. Whilst basic criteria are applied to all authorised institutions on an individual basis to allow for any particular circumstances, the supervisory system still relies considerably upon regular, close contact being maintained between the Bank of England and the management of the individual institutions, together with the monitoring capacity afforded by the submission to the Bank of England of quarterly statistical returns from all authorised institutions.

There are currently some 600 plus authorised institutions, split almost equally between recognised banks and licensed deposit takers. Around two thirds of the institutions supervised are foreign-owned or foreign-controlled and the developments which have come about in international supervisory co-ordination and co-operation over recent years have had an influence on the UK system of control.

As to the future, it would seem reasonable to assume that some changes in the supervisory system will be brought about by the various influences which will impact on markets and thus create the need for supervisory responses. Technological changes, the emergence of new types of institutions, competitive pressures and a continued increasing involvement in international banking may all play a part, as will further European integration. Due to the spread of automated teller machine networks and the likely early introduction of electronic funds transfer at point of sale, the use of paper in payments' systems could virtually be eliminated and this would enable institutions other than banks (e.g. building societies) to provide increasingly cash dispensing and money transmission services in competition with banks but without the heavy operating costs of the present paper-based system. Links between institutions providing similar financial services could be made and this could well spread beyond mere collaboration between banks and building societies, should "financial supermarkets" be created providing a very wide range of financial services and perhaps embracing banks, building societies, insurance companies, multiple retail chains and possibly others. Such changes would certainly raise the question of the suitability of many of

the capital and liquidity ratios and the other monitoring tools currently regarded as appropriate for banks; furthermore if considerable diversification does take place the matter of ownership would need to be considered in a supervisory context.

Thus both international and domestic developments in banking and other institutions will affect the way in which banks are supervised in the future, and the Bank of England and other authorities may well face difficult judgments in dividing what sort of balance should be struck between their providing a lead and allowing market forces to operate.

Indeed, after a relatively calm period since the introduction of the Banking Act, there have recently been disturbing instances within the banking community which have again raised the thorny problem of bank regulation. This, together with the continued concern internationally over the pressures now applying to commercial banks, means that the whole question of the supervision of banks will remain an active one for the foreseeable future.

THE NATURE OF THE BANKING CONTRACT

As with any contract, the banking contract involves rights and duties and over the years the terms of the contract have gradually been clarified by means of decided cases. The main terms of the contract are however implied and there is no statute which covers the subject and (at least in the UK) there is no precise written or even oral notification of the terms of the contract. The relationship of banker and customer has several facets and the terms relating to these are given consideration from time to time in the courts and in this way the terms are tested, clarified and perhaps defined as time goes by.

The CONTRACTUAL aspects of the banker/customer relationship are examined more fully below. As a customer must be an account holder, the basic relationship between banker and customer is that of DEBTOR AND CREDITOR, the banker being the debtor with regard to funds deposited with him, and being the creditor in respect of money lent by him. However, a banker is not an ordinary debtor as a banker is liable to repay only when demand has been made on him whereas under Common Law an ordinary debtor has a duty to seek out his creditor and repay the debt. Although in past years efforts have been made to get the courts to rule whether a banker was a trustee for his customer, an agent of the customer or bailee of his customer's property. These all involve to some extent the holding of money or property by one party for another. Nevertheless, so does a debtor since he is holding money of his creditor and, although different roles arise in an overall banker and customer relationship, the fundamental relationship can be regarded as that of debtor and creditor. In providing ancillary services for the customer the question of other relationships arises and the PRINCIPAL AND AGENT relationship rears its head where the banker acts for his customer where a third party is involved. The law relating to Agency is therefore relevant to bankers because they will act on occasions as agents on behalf of their

customers and also because many of their normal business transactions will involve their having dealings with other agents, e.g. company directors, partners and attorneys. The other important relationship which arises is that of BAILOR AND BAILEE in instances where bankers are holding for safe keeping their customers' valuables and securities.

It is therefore necessary for bankers to understand the principles involved in these different types of relationship so that they can conduct their banking business and transactions in full knowledge of the various rights and obligations which may apply. The various relationships are explained in more depth below.

THE CONTRACTUAL RELATIONSHIP

The implied terms and conditions of the contract between banker and customer were mainly defined in *Joachimson v. Swiss Bank Corporation* (1921):

(a) the bank undertakes to receive money, and
(b) to collect bills for its customers' account.
(c) The proceeds received, under (a) and (b) are not held in trust but borrowed by the banker, who undertakes
(d) to repay them at the branch where the account is kept and during banking hours, and
(e) to repay any part of the amount due against the written order of the customer.
(f) As such written orders (cheques) may be outstanding for some days the banker undertakes not to cease business with his customer without reasonable notice.
(g) The banker is not liable to repay until demand has been made by the customer. (Notice that this is the opposite of the ordinary rule that a debtor must seek out his creditor and that, as a result, the Limitation Act does not commence to run against the **customer** until demand has been made).
(h) The customer undertakes to exercise reasonable care in drawing his cheques so as not to mislead the bank or to facilitate forgery.
(i) The banker owes a duty of secrecy.

BANKER'S DUTY OF SECRECY

This is an important topic and one which can rear its head in practice in a variety of ways. Failure to observe this obligation on the part of a banker can cause serious problems and involve loss by way of damages, and it is therefore an area with which the banker needs to be fully familiar. Breach of the duty of secrecy will give a claim for nominal damages or, where it can be shown that the customer has suffered injury, for substantial damages. Quite apart from any monetary cost which could thus be incurred, there is also the danger of the banker's reputation being seriously harmed by the bad publicity that could be