Chapter III

Payment Instruments in India

3.1. Currency[1] is an important means of payment in India, with 19% of M3 represented by currency, as against its share of 6 to 7% in advanced countries. It is supplemented by cheques and drafts for payments in commercial transactions. Various other paper instruments like a Banker's cheque, Payment order, Payable 'At Par' cheques (Interest/Dividend warrants, refund orders, gift cheques etc.), are also used to cater to the specific payment needs. The statutory basis for these instruments was provided by the Negotiable Instruments Act, 1881 (NI Act).

3.2. The NI Act, 1881, defines a Negotiable Instrument as a promissory note, Bill of Exchange or cheque. A Bill of Exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument. A Hundi is a Bill of Exchange in an Indian language, governed by customs and local usage. The NI Act, however, does not govern Hundis. A Bill of Exchange may therefore, include a Hundi, but Hundi may not be a Bill of Exchange.

3.3. A cheque is a Bill of Exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. The maker of a cheque is called the 'drawer', and the person directed to pay is the 'drawee'. The person named in the instrument, to whom or to whose order the money is, by the instrument directed, to be paid, is called the 'payee'. A cheque is a Negotiable Instrument, which can be further negotiated by means of endorsement and is payable on demand. A cheque payable to bearer is negotiable by the delivery thereof, and when it is payable to order is negotiable by the holder by endorsement and delivery thereof. A cheque has to be presented for payment by the payee or holder to the acceptor, maker or drawer. A cheque payment is a debit transaction as the transaction regarding the payment of a cheque is initiated by the payee or beneficiary.

[1] Reserve Bank of India assumed responsibility of note issue from the Controller of Currency in 1935. The sole right to issue bank notes vests with the Reserve Bank under Section 22, of the RBI Act 1934. In terms of Section 23, of the RBI Act 1934, the Issue Department handles the work relating to the issue of bank notes. The Government, however, continued to issue Currency Notes, i.e. Re.1 notes till 1994.

3.4. A cheque is not cash, as it does not assume the finality of payment. The funds may not be available with the drawer or the drawer may have withdrawn funds from his bank account in the interim leading to the possibility of the cheque being dishonoured on presentation. In addition, the banks levy a collection charge based on postal costs as well as the value of the cheque in case of outstation cheques. It takes time to realise the proceeds of a cheque payment, especially if the cheque is an outstation one. For these reasons, the cheque is not always acceptable in several business transactions particularly where the drawer and the payee are notknown to each other. In many commercial transactions, the sellers of goods and services prefer to have a payment instrument where the sum of money payable to the payee is guaranteed. The demand draft is one such instrument.

3.5. The Demand Draft is a pre-paid Negotiable Instrument, wherein the drawee bank undertakes to make payment in full when the instrument is presented by the payee for payment. The demand draft is made payable on a specified branch of a bank at a specified centre. In order to obtain payment, the beneficiary has to either present the instrument directly to the branch concerned or have it collected by his / her bank through the clearing mechanism.

3.6. Banker's cheque is another payment instrument which is used by banks to settle payment obligations on behalf of their customers. This instrument is guaranteed by the bank for its full value and is similar to a demand draft. In practice, these instruments are payable at the branch of issue and are used for payment within the local clearing jurisdiction.

3.7. Payment Orders are issued by banks for payments made on behalf of the bank. These instruments are signed by a banker and carry the guarantee of the bank on the availability of the funds. These instruments are payable at the branch of issue.

3.8. Carrying large amounts of cash is very risky, especially when one is travelling. Travellers cheques are a secure and convenient alternative to carrying cash. These are prepaid instruments available in fixed denominations. The holder of the Travellers cheque is required to sign the instrument upon purchase and again in the presence of the merchant establishment at the time of making payment or realising proceeds thereof. Travellers cheques can be replaced if they are lost or stolen at no additional cost. Travellers cheques are available in both domestic and international currency. These instruments can be readily exchanged at bank branches anywhere and in several merchant establishments.

3.9. The payment of periodic interest on fixed deposits with companies as well as government securities is a different class of payment for which a special type of payment instrument called an Interest Warrant is issued. These are special types of cheques which are 'payable at par' in various branches of a bank across the country. The term 'at par' indicates that the full face value of the instrument has to be credited to the account of the payee, without recourse to any deductions in the form of collection charges, which banks usually levy whenever an instrument is sent for collection. Dividend warrants too are similar to the interest warrants and are usually payable 'at par' to the shareholders of a company[2].

3.10. Interest warrants have been in vogue for a very long time, as can be recognised by the fact that servicing of public debt entails payment of interest to holders of Government Securities. The servicing of public debt is done by the Public Debt Office of Reserve Bank of India, which issues interest warrants, payable 'at par' at all offices of Reserve Bank of India and State Bank of India.

3.11. Interest or Dividend warrants and refund orders are issued by the companies with a prior funding arrangement with a bank. The company funds an account with the bank with a sum equal to at least the total value of the interest warrants proposed to be issued. The bank, provides the 'at par' facility whereby the instruments drawn on that particular bank are payable at par in selected branches of the bank as also the branches of the correspondent bank at various centres across the country. These warrants are honoured by the paying branches and the funding account of the company is debited.

3.12. Corporate clients are also extended the facility to issue Current Account Cheques 'at par' by their bankers on a very selective basis. This is largely done to facilitate payments to upcountry suppliers and others. Similarly for payments from retailers and other upcountry buyers of corporate products, banks offer collection accounts facilities to reputed companies. The payments to the company are channelled through special accounts throughout the country and repatriated to the headquarters' account.

3.13. The payment instruments described above are all paper based and require to be tendered at specific banks for payment either in person or through another bank in clearing or through collection. Under the N.I. Act, 1881, the cheque or the instrument has to be presented to the drawer. The chief disadvantage with the cheque and the demand draft is that these instruments have to be physically presented, often leading to delays in payment. To overcome delays, fund transfers through the medium of Telex were introduced. The Telegraphic Transfers represent payment instructions sent in a telex mode to an upcountry branch of the same bank or to a correspondent bank branch to credit the beneficiary's account with a given amount. A cipher code is appended to the text of the message to ensure its integrity and authenticity during transit.

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[2] Section 205, sub-section 5 of the Companies Act, permits a company to pay any dividend payable in cash, either by cheque or warrant. Section 206, sub-section 1(a), reiterates that the dividend amount should be paid only to the registered shareholder or to his order or to his banker.

3.14. Cheque volumes have risen substantially through the last three decades as can be seen from Figure 3.1. Cheque volumes have risen steadily in all urban centres, their growth in metropolitan centres and other major cities being much faster than the rest. Mumbai, for example, has a substantially higher volume than the other metropolitan centres. In recent times, cheque volumes in cities such as Ahmedabad, Surat and Vadodara have registered sharp increases.

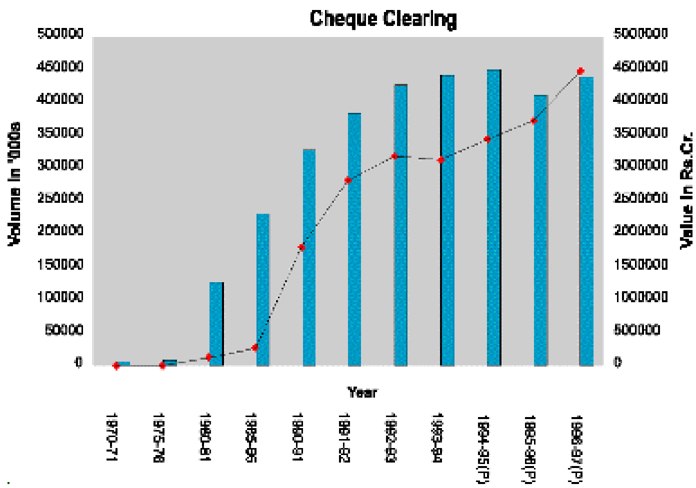

Figure 3.1. Growth in Cheque Clearing - Volumes and Value
(1 Crore = 10 million)

The growth of cheque volumes could be attributed partly to the rapid expansion of bank branches through the seventies and the consequent spread of banking as also partly to the increasing tendency of the people to invest in financial assets like shares and debentures. There has also been a significant growth in such corporate instruments as fixed deposits. This is reflected in the substantial increase in the use of payable 'At Par' instruments for dividends, interests and refund orders.

3.15. The substantial increase in the volumes of cheques indicates the need for upgrading the existing infrastructure for exchange and settlement from manual clearing arrangement to more efficient and electronically driven systems. Manual sorting and listing of instruments result in long delays as well as errors in computation of the total claims. The settlement process itself would get delayed and result in the problem of unreconciled entries between the banks.

3.16. Another important payment instrument which is widely popular is the Money Order service offered by the Department of Posts, Government of India. The Money Order enables an individual to send remittances to a third party under the aegis of the Post Office. It is a point-to-point delivery of funds. The originating Post Office collects the full amount of remittance as also a commission (service charge) from the individual remitting the funds and sends the advice to the destination Post Office. At the destination Post Office, the funds are paid to the beneficiary. The money order can be sent as an ordinary paper based payment advice or as a Telegraphic Money Order. The Telegraphic Money Order is faster as the payment advices are sent through Telex or Telegraph. The customer, of course, has to pay higher service charges for this facility.

3.17. The Postal Order is another payment instrument of the Department of Posts. The Postal Order is issued denomination-wise, which can be encashed by the beneficiary after due identification at the Post Office on which it is drawn. Postal Orders like the Money Orders are independent of the banking system. Both these instruments are GIRO payments and are credit transactions as opposed to a cheque which is a debit payment mechanism.