LOVELY PROFESSIONAL UNIVERSITY

BANKING THEORY AND PRACTICE

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Printed by
EXCEL BOOKS PRIVATE LIMITED
A-45, Naraina, Phase-I,
New Delhi-110028
for
Lovely Professional University
Phagwara

SYLLABUS

Banking Theory and Practice

Objectives:

- Students will get exposure for banking operations
- Students will be exposed to various dimensions of day to day operations.
- Students will have practical applications of banking aspects in real life situations

S. No.	Description
1.	***Banks:*** Meaning, nature, characteristic of Indian banking system, functions of commercial banks – primary functions; secondary functions; agency functions and general utility functions, role of banks in the development of economy (Financial Inclusion).
2.	***Indian Banking System:*** History, Classification & Present scenario, Reserve Bank of India: role and functions, techniques of credit control.
3.	***Credit creation:*** Meaning, process, limitation of credit creation.
4.	***Banker Customer Relationship:*** Various types of relationship, KYC norms, Special types of accounts, Mandate & power of attorney, Banker's Lien, Right of Set off, Garnishee Order and Attachment order.
5.	***Type of Deposit Account:*** Process of opening bank accounts, pay in slip, Cheque book, pass book, ATM cum Debit card, Credit Card, advantages of bank account, No Frill Account, Loan and Advances: Introduction, classification of loans, principles of good lending, loan procedure followed by banks, Evaluating consumer and commercial loans.
6.	***Banking Systems:*** Corporate banking, Retail banking and Merchant banking, Treasury Management, Cash management system: concept of Cash Management Services for Corporate entity.
7.	***Negotiable Instruments:*** Definition and features of Cheques, Bills of exchange, Promissory note, Holder, Holder in due course, Paying Banker & Collecting Banker: right & liabilities, Reasons for dishonour of cheques, Crossing of Cheques, Endorsement of a Cheque.
8.	***Banking Sector Reforms:*** Liberalization of banking sector, Narsimham Committee-1st and 2nd generation reforms, Capital adequacy: introduction, Basel II norms (new capital adequacy frame work).
9.	***Non Performing Assets (NPA's):*** Introduction, classification of NPAs, provisions for NPA's, management of NPA's.
10.	Core banking Solution, RTGS, NEFT, EFT, ALM, AML. E- banking: Introduction of e banking, E-cheques, advantages and disadvantages of e banking, Cheque Truncation, mergers of banks, Global banking activities.

CONTENT

Unit 1:	Introduction to Banks *Rupesh Roshan Singh, Lovely Professional University*	1
Unit 2:	Role of Banks in the Development of Economy *Rupesh Roshan Singh, Lovely Professional University*	15
Unit 3:	Indian Banking System *Rupesh Roshan Singh, Lovely Professional University*	32
Unit 4:	Credit Creation *Rupesh Roshan Singh, Lovely Professional University*	53
Unit 5:	Banker Customer Relationship *Rupesh Roshan Singh, Lovely Professional University*	67
Unit 6:	Type of Deposit Account *Mahesh Kumar Sarva, Lovely Professional University*	82
Unit 7:	Loans and Advances *Mahesh Kumar Sarva, Lovely Professional University*	96
Unit 8;	Banking Systems *Mahesh Kumar Sarva, Lovely Professional University*	121
Unit 9:	Cash Management System *Mahesh Kumar Sarva, Lovely Professional University*	144
Unit 10:	Negotiable Instruments *Mahesh Kumar Sarva, Lovely Professional University*	155
Unit 11:	Banking Sector Reforms *Tanima Dutta, Lovely Professional University*	176
Unit 12:	Capital Adequacy *Tanima Dutta, Lovely Professional University*	190
Unit 13:	Non Performing Assets *Tanima Dutta, Lovely Professional University*	201
Unit 14:	Core Banking Solution *Tanima Dutta, Lovely Professional University*	226

Notes

Unit 1: Introduction to Banks

CONTENTS

Objectives

Introduction

1.1 Meaning and Nature of Bank

1.1.1 Origin of the Word 'Bank'

1.2 Characteristics of Indian Banking System

1.3 Functions of Commercial Banks

1.3.1 Primary Functions

1.3.2 Secondary Functions

1.4 Agency Functions and General Utility Functions

1.5 Summary

1.6 Keywords

1.7 Review Questions

1.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the meaning and nature of bank
- Discuss about the origin of the bank
- Discuss the characteristics of Indian Banking System
- Describe functions of commercial banks
- Elaborate the agency functions and general utility functions

Introduction

This unit will help you to understand the meaning and nature of bank. The various section and sub-section of this unit will also summarize the characteristics of Indian Banking System and several functions of commercial banks. The banking system in India is significantly different from that of other Asian nations. In this unit, you will study about the banks. Banks play a key role in growth of a nation and its economy. Banks provides a number of services which can be categorized on the bases of different criteria. A bank takes in money from one group of people (depositors) and lends it to another (borrowers). It is (almost) certain that it will have to repay depositors; it is not certain that it will be repaid by borrowers. This means that there must be a gross profit margin made from loans advanced which can be set against borrower defaults. The business of lending is the same as any other business, in that increased profit comes at the expense of increased risk. Thus a bank may lend either at very high rates to very risky borrowers and hope that the default rate is sufficiently low to leave it in profit or at very low rates to

Notes

creditworthy borrowers and hope that the profit margin is sufficient to cover any loss which does occur.

1.1 Meaning and Nature of Bank

A bank is an institution, usually incorporated with power to issue its promissory notes intended to circulate as money (known as bank notes); or to receive the money of others on general deposit, to form a joint fund that shall be used by the institution, for its own benefit, for one or more of the purposes of making temporary loans and discounts; of dealing in notes, foreign and domestic bills of exchange, coin, bullion, credits, and the remission of money; or with both these powers, and with the privileges, in addition to these basic powers, of receiving special deposits and making collections for the holders of negotiable paper, if the institution sees fit to engage in such business.

Banking in the modern sense of the word can be traced to medieval and early Renaissance Italy, to the rich cities in the north like Florence, Lucca, Siena, Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14th century Florence, establishing branches in many other parts of Europe. One of the most famous Italian banks was the Medici Bank, set up by Giovanni di Bicci de' Medici in 1397. The earliest known state deposit bank, Banco di San Giorgio (Bank of St. George), was founded in 1407 at Genoa, Italy.

In ancient India there is evidence of loans from the Vedic period (beginning 1750 BC). Later during the Maurya dynasty (321 to 185 BC), an instrument called adesha was in use, which was an order on a banker desiring him to pay the money of the note to a third person, which corresponds to the definition of a bill of exchange as we understand it today. During the Buddhist period, there was considerable use of these instruments. Merchants in large towns gave letters of credit to one another.

The definition of a bank varies from country to country. Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as:

- conducting current accounts for his customers,
- paying cheques drawn on him/her, and
- collecting cheques for his/her customers.

In most common law jurisdictions there is a Bills of Exchange Act that codifies the law in relation to negotiable instruments, including cheques, and this Act contains a statutory definition of the term banker: banker includes a body of persons, whether incorporated or not, who carry on the business of banking'. Although this definition seems circular, it is actually functional, because it ensures that the legal basis for bank transactions such as cheques does not depend on how the bank is organized or regulated.

The business of banking is in many English common law countries not defined by statute but by common law, the definition above. In other English common law jurisdictions there are statutory definitions of the business of banking or banking business. When looking at these definitions it is important to keep in mind that they are defining the business of banking for the purposes of the legislation, and not necessarily in general. In particular, most of the definitions are from legislation that has the purposes of entry regulating and supervising banks rather than regulating the actual business of banking. However, in many cases the statutory definition closely mirrors the common law one.

Since the advent of EFTPOS (Electronic Funds Transfer at Point Of Sale), direct credit, direct debit and internet banking, the cheque has lost its primacy in most banking systems as a payment instrument. This has led legal theorists to suggest that the cheque based definition should be

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broadened to include financial institutions that conduct current accounts for customers and enable customers to pay and be paid by third parties, even if they do not pay and collect checks.

H.L. Henry defined a banker as, "*One who in the ordinary course of business honours cheques drawn upon by persons from and for whom he received money on current account*". This definition is very restrictive in the sense that any person or institution engaged in the business of attracting deposits may be called as bank.

Kinley's definition, "*A bank is an establishment which makes to individuals such advance of money as may be required and safely made and to which individuals entrust money when not required by them for use*".

The definition of R.S. Sayers, however, reveals the true character of a modern bank. In his words, "*Banks are institution whose debts usually referred to as bank deposits are commonly accepted in final settlement of other people's debts*".

Under British Law, "*A banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current accounts*". (Dr. Herbert L. Hart)

Under Indian law, Banking Regulation Act of India, 1949, "*Accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft and order or otherwise*" (Section 5b).

1.1.1 Origin of the Word 'Bank'

The name bank is derived from the Italian word banco "desk/bench", used during the Renaissance by Florentine's bankers. These bankers used to make their transactions above a desk covered by a green tablecloth.

There are traces of banking activity even in ancient times. In fact, the word traces its origins back to the ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed *courtyards called macella on a long bench called a bancu.* It is from here that the words banco and bank are derived.

As a money changer, the merchant at the banco did not invest much money but merely converted the foreign currency into the only legal tender in Rome that is the Imperial Mint.

In simple terms, a bank is an institution that accepts various types of deposits and then advances money in form of loans to people requiring it.

Money and credit provide the pivot (axle) around which all the economic activities revolve. Banks are institutions, which accept deposits and use these funds to grant loans. Banks collect the surplus funds of millions of individual savers who are widely scattered. The money so collected is channelised to the investors i.e. people asking for loans for further investment purposes.

Banks help in money growth and capital formation. They are reservoirs of resources for economic growth and development of the nation. They help in building the infrastructure, boosting the agriculture, setting up industries and aid to global trade. Thus, a bank, by discharging its functions effectively enhances the productive and industrious capacity of the nation and boosts the pace of growth. Banks are the heart of the financial system.

Notes Banks are a medium through which economic and fiscal policies of the government are materialized.

Financial sector reforms were initiated in India in early 90s with a view to improving efficiency in the process of financial intermediation; these reforms have facilitated greater choice for

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consumers, who have become more discerning and demanding, compelling banks to offer a broader range of products through diverse distribution channels. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as their defining attribute. The Indian financial system is identified with two set of institutions viz. regulators and intermediaries. Regulatory Institutions are statutory bodies assigned with the job of monitoring and controlling different segments of the Indian Financial System (IFS). These institutions are given adequate powers through the vehicle of their respective Acts to enable them to supervise the segments assigned to them.

It is the job of the regulator to ensure that the players in the segment work within recognized business parameters maintain sufficient level of disclosure and transparency of operations and do not act against the national interests. At present, there are two regulators directly connected to Indian financial system. They are Reserve Bank of India and Security and Exchange Board of India. Intermediary financial institutions include banking and non banking financial institutions. The banking financial institutions participate in the economy's payments mechanism, i.e., they provide transaction services, their deposit liabilities constitute a major part of the national money supply, and they can, as a whole, create deposits or credit, which is money. Banks, subject to legal reserve requirements, can advance credit by creating claims against themselves. Other financial institutions can lend only out of resources put at their disposal by the savers.

Did u know? Financial institutions are the primary source of long term lending for large projects.

Conventionally, they raised their resources in the form of bonds subscribed by RBI, Public Sector Enterprises, Banks and others. With the drying up of concessional long-term operations funds from the Reserve Bank in the early 1990s, financial institutions have increasingly raised resources at the short end of the deposit market.

Caution The Banking Segment in India functions under the regulation of Reserve Bank of India.

This segment broadly consists of commercial banks and cooperative banks. Non-banking Financial Institutions carry out financing activities but their resources are not directly obtained from the savers as debt. Instead, these Institutions mobilize the public savings for rendering other financial services including investment. All such institutions are financial intermediaries and when they lend, they are known as Non-banking Financial Intermediaries (NBFIs) or investment institutions.

Example: Unit Trust of India, Life Insurance Corporation (LIC) and General Insurance Corporation (GIC).

Apart from these NBFIs, another part of Indian financial system consists of a large number of privately owned, decentralized, and relatively small-sized financial intermediaries. Most work in different, miniscule niches and make the market more broad-based and competitive. While some of them restrict themselves to fund-based business, many others provide financial services of various types. The entities of the former type are termed as "Non-bank Financial Companies (NBFCs)". The latter type is called "Non-bank Financial Services Companies (NBFSCs)".

The commercial banking structure in India consists of two major set of players scheduled commercial banks and unscheduled banks. The scheduled commercial banks constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide

section 42 (60) of the Act. This sub sector broadly consists of private sector banks, foreign banks. The banking sector is dominated by Scheduled Commercial Banks (SCBs).

Self Assessment

Fill in the blanks:

1. There are traces of banking activity even in …….. times.
2. Banks are a medium through which economic and fiscal …….. of the government are materialized.
3. Financial institutions are the primary source of long term ……. for large projects.

1.2 Characteristics of Indian Banking System

From the meaning and nature of banks mentioned in earlier section, the characteristics/features of a bank may be listed as follows:

1. ***Dealing in Money:*** Bank is a business activity which deals with other people's money i.e. getting money from depositors and lending the same to borrowers.
2. ***Banking Business:*** A bank is a financial institution which does banking activities of selling financial services like home loans, business loans, lockers, fixed deposit etc. In order to enable people to confirm that it is a bank and is dealing in money, for easy identification, a bank should add the word "bank" as its last name.
3. ***Acceptance of Deposit:*** A bank accepts money from the people in the form of deposits where there is an obligation to refund deposits on demand or after the expiry of a fixed tenure as they feel it is a safest place to deposit money.
4. ***Lending Money:*** A bank provides advance money in the form of loans to needy persons for promotion & development of business, purchase of home, car etc.
5. ***Easy Payment and Withdrawal Facility:*** Payment & Withdrawal of money can be made through issuance of cheques & drafts, ATM, Online Fund Transfer without the need for carrying money in hand. A bank provides easy payment and withdrawal facility to its customers in the form of cheques, drafts, ATM's and ETF.
6. ***Motive of Profit with Service Orientation:*** A Bank has a motive of employing funds received as deposits from the public in a profitable manner with service oriented approach.
7. ***Linking Bridge:*** Banks collect money from those who have surplus money and give the same to those who are in need of money. It acts as a trust/custodian of funds of its customers.

Notes A bank acts as a bridging link between borrowers and lenders of money.

8. ***Ever increasing Functions:*** Banking is an evolutionary concept. There is continuous expansion and diversification as regards the functions, services and activities of a bank.
9. ***Banking Business:*** A bank's main activity should be to do business of banking which should not be subsidiary to any other business.
10. ***Name Identity:*** A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.

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Self Assessment

Fill in the blanks:

4. A bank provides easy payment and ……. facility to its customers in the form of cheques, drafts, ATM's, ETF.
5. A bank is a financial institution which does ……. activities of selling …… services.
6. A bank provides advance money in the form of loans to needy persons for …….. & development of business.

1.3 Functions of Commercial Banks

The functions of commercial banks are divided into two categories:

(i) Primary functions, and (ii) Secondary functions including agency functions.

1.3.1 Primary Functions

The primary functions of a commercial bank include:

(a) Accepting deposits; and

(b) Granting loans and advances;

(a) ***Accepting Deposits:*** The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned.

Example: If the rate of interest is higher, public are motivated to deposit more funds with the bank.

There is also safety of funds deposited with the bank.

(b) ***Grant of Loans and Advances:*** The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the loans is the main source of a bank's income.

(i) *Loans:* A loan is granted for a specific time period. Generally, commercial banks grant short-term loans. But term loans, that is, loan for more than a year, may also be granted.

The borrower may withdraw the entire amount in lump-sum or in installments. However, interest is charged on the full amount of loan. Loans are generally granted against the security of certain assets. A loan may be repaid either in lump-sum or in installments.

(ii) *Advances:* An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but

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advances are normally granted for a short period of time. Further, the purpose of granting advances is to meet the day to day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

Modes of short-term financial assistance: Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

(i) ***Cash Credit:*** Cash credit is an arrangement whereby the bank allows the borrower to draw amounts upto a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash credit is granted as per agreed terms and conditions with the customers.

(ii) ***Overdraft:*** Overdraft is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit is allowed either on the security of assets, or on personal security, or both.

(iii) ***Discounting of Bills:*** Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonoured on the due date, the bank can recover the amount from the customer.

Task Visit a commercial bank and study the conditions on which it issues loans and advances to its clients.

Caselet

United Bank of India Corporate Loans

United Bank of India corporate loans are given to a wide swathe of industries that include housing finance companies, large corporate, and Non-banking Financial Corporation's (NBFCs). Minimum loan amount is ₹ 25 crores. The loan can be utilized for establishing new units and modernizing old ones. Both infrastructure and non-infrastructure sectors are covered under the scheme. Export Credits are also permitted.

Priority Sector Loans

United Bank of India priority sector loans covers the following different types:

- Small Scale Industries
- Retail Trade
- Agricultural Loans

Retail Sector Loans

United Bank of India Retail Sector loans cover the following products:

- United Smart Loan Scheme
- United Personal Loan Scheme for Salaried Persons

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- United Personal Loan Scheme for Pensioners
- United Tour & Travel Credit Scheme

United Bank of India Educational Loans

United Bank Of India educational loans are also available. Maximum loan limit for studying in India is ₹ 7.5 lakhs. The loan limit for studying abroad is ₹ 15 lakhs.

Source: http://business.mapsofindia.com/banks-in-india/united-bank-of-india-loans.html

1.3.2 Secondary Functions

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows:

(a) Issuing letters of credit, travellers' cheques, circular notes etc;

(b) Undertaking safe custody of valuables, important documents, and securities by providing safe deposit vaults or lockers;

(c) Providing customers with facilities of foreign exchange;

(d) Transferring money from one place to another; and from one branch to another branch of the bank;

(e) Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc;

(f) Collecting and supplying business information;

(g) Issuing demand drafts and pay orders; and

(h) Providing reports on the credit worthiness of customers.

Self Assessment

State whether the following statements are true or false:

7. Loans may be granted only for long periods by banks.
8. Primary activity of commercial banks includes accepting deposits and lending money.
9. Difference of interest allowed to public on deposits and charged on loan is the main source of income of banks.

1.4 Agency Functions and General Utility Functions

You have already learnt that the primary activities of commercial banks include acceptance of deposits from the public and lending money to businessmen and other members of society. Besides these two main activities, commercial banks also render a number of ancillary services. These services supplement the main activities of the banks. They are essentially non-banking in nature and broadly fall under two categories:

1. Agency services, and
2. General utility services.

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1. ***Agency Services:*** Agency services are those services which are rendered by commercial banks as agents of their customers. They include:
   (a) Collection and payment of cheques and bills on behalf of the customers;
   (b) Collection of dividends, interest and rent, etc. on behalf of customers, if so instructed by them;
   (c) Purchase and sale of shares and securities on behalf of customers;
   (d) Payment of rent, interest, insurance premium, subscriptions etc. on behalf of customers, if so instructed;
   (e) Acting as a trustee or executor;
   (f) Acting as agents or correspondents on behalf of customers for other banks and financial institutions at home and abroad.
2. ***General Utility Services:*** General utility services are those services which are rendered by commercial banks not only to the customers but also to the general public. These are available to the public on payment of a fee or charge. They include:
   (a) Issuing letters of credit and travellers' cheques;
   (b) Underwriting of shares, debentures, etc.;
   (c) Safe-keeping of valuables in safe deposit locker;
   (d) Underwriting loans floated by government and public bodies;
   (e) Supplying trade information and statistical customers;
   (f) Acting as a referee regarding the financial status;
   (g) Undertaking foreign exchange business.

Self Assessment

Fill in the blanks:

10. Agency functions include purchase and sale of shares and …… on behalf of customers.
11. General utility services comprises of …….. of shares and debentures.

Case Study

The Rise and Fall of Global Trust Bank

"GTB had been sliding for several months now. Perhaps enough vigilance was not maintained in the past."

– P Chidambaram, Union Finance Minister of India

"I would have loved to see Global Trust Bank remain as an independent entity, but in the best interests of depositors and employees this is the best decision."

– Ramesh Gelli, Founder Promoter, Global Trust Bank (GTB)

"It is a big relief that GTB is to be merged with Oriental Bank of Commerce. I have decided never to park any money with a private sector entity."

– A Depositor of GTB

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The case describes the growth and collapse of Global Trust Bank, a leading private sector bank in India. Since 2001, GTB's name was associated with scams and controversies, thereby casting shadows over the credibility of the bank and its management.

Due to the overexposure to capital markets and huge NPAs, the bank was in a financial mess.

When GTB tried to cover up its monumental NPAs through under provisioning, RBI - the Central bank and the regulatory authority for banks in India, appointed an independent team to review the finances of the bank. The review revealed various financial discrepancies kept covered by the bank. RBI imposed a three month moratorium on GTB on the ground of "wrong financial disclosures" and within two days the bank was merged with Oriental Bank of Commerce (OBC), a public sector bank. With the merger becoming effective, GTB's identity came to an end and it became a part of OBC.

The Moratorium

On July 24, 2004, the Government of India imposed a moratorium on Global Trust Bank (GTB), a leading private sector bank, on the grounds of 'wrong financial disclosures.' The moratorium was for three months from close of business on July 24, 2004 till October 23, 2004. Earlier, the Reserve Bank of India (RBI) had announced that GTB's net worth had turned negative as it had incurred huge losses and accumulated a significant number of Non-performing Assets (NPAs). RBI stated that the numbers reported in GTB's balance sheet did not match its audited figures. Moreover, GTB failed to provide satisfactory explanations to most of RBI's queries regarding its capital market exposures and why prudent lending norms were not observed in disbursing huge amounts for investments in the stock market. RBI said the moratorium was imposed in public interest and to protect the interests of depositors. All operations of GTB were frozen and it was ordered not to give loans without RBI permission. It was allowed only to make payments for day-to-day operations or for meeting obligations entered into before the order.

Background Note

The liberalization process initiated by the Government of India, during the early 1990s witnessed the entry of several private players in the Indian banking sector. GTB was one of the earliest private sector banks to be incorporated on October 30, 1994, in Hyderabad. GTB was promoted by Jayant Madhab (Madhab), Ramesh Gelli (Gelli) and Sridhar Subasri (Subasri). Madhab, a development banker, was employed with the Asian Development Bank, Manila. Gelli who was Chairman of Vysya Bank for 10 years had played a major role in transforming that bank into one of India's top private sector banks. Subasri was a former bank executive and a close friend of Gelli.

Though the licence to GTB was given in the name of Jayant Madhab and Associates, Madhab's involvement with GTB was affected by the loss of his only son. The bank's operations were managed by Gelli. Apart from the three promoters, the International Finance Corporation (IFC) and the Asian Development Bank (ADB) were the bank's major shareholders. GTB offered an array of products and services in retail, wholesale, corporate, treasury and investment banking and products for non-resident Indians, apart from depository and advisory services. The bank specialized in lending to the software, energy, telecom, textiles, pharmaceuticals and gems and jewellery sectors. Since its inception, GTB had been in the news several times. The three promoters raised ₹ 400 mn, considered a substantial amount for individual promoters. With two international financial institutions – IFC and ADB - as shareholders, GTB became the first Indian private sector bank to attract equity participation from international investment banks.

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The Initial Public Offer (IPO) in late 1994 was oversubscribed 60 times. Subscription worth ₹ 62.40 bn from over one mn investors was received as against the original size of ₹ 1.04 bn. On opening day, the bank reportedly received deposits worth ₹ one bn, which increased to ₹ 10 bn by the end of the first year; and ₹ 27.06 bn in three years.

In three years of operations, the total business exceeded ₹ 43.02 bn, making it one of the fastest growing banks in India. It was also the first among Indian banks to raise Tier II capital from multilateral institutions. In five years, GTB's deposits were worth ₹ 40 bn out of which 70 per cent were from retail investors.

The Fall

The collapse of GTB resulted from many mistakes committed by the bank's management. GTB's problems started in 2000 and the imposition of the moratorium finally ended its independent existence.

RBI's probe into GTB's accounts revealed a significant erosion of the bank's net worth and huge number of NPAs reflected its weak financials. Moreover, GTB's attempts to strengthen its capital base through investments from overseas failed due to regulatory problems, resulting in the total collapse of the bank.

Nexus With Ketan Parekh

In mid-2000, GTB disbursed loans of ₹ 1.4 bn to Ketan Parekh (KP), a leading stockbroker at the Bombay Stock Exchange (BSE). He used the money to purchase GTB shares from the BSE and the National Stock Exchange (NSE).

The Merger

All these factors resulted in the imposition of moratorium by RBI on GTB. On July 26, 2004, RBI announced that GTB would be merged with the Oriental Bank of Commerce (OBC).

As per the scheme, OBC took over all the assets and liabilities of GTB on its books. It acquired all 104 branches of GTB, 275 ATMs, a workforce of 1400 employees and one million customers at an estimated merger cost of ₹ 8 bn. OBC's total business volume was expected to reach ₹ 65 bn and the total branch network to cross 1,100. All corporate accounts including salary accounts were transferred to OBC. The entire amount of paid-up equity capital of GTB was adjusted towards its liabilities. There was no share swap between GTB and OBC, which meant that GTB shareholders were the ultimate losers, as they did not get any shares of OBC. Moreover, OBC enjoyed a huge tax break by acquiring GTB's NPAs worth ₹ 1.2 bn and impaired assets of ₹ 3 bn.

The Aftermath

Though RBI's decision to merge GTB with OBC came as a relief for the former's depositors, analysts and industry experts raised concerns about the way RBI handled the entire issue. They said RBI had announced the merger of GTB and OBC, in less than 48 hours of the imposition of the moratorium.

If the deal was already in process, they wondered why RBI took the extreme measure of imposing a moratorium instead of announcing the mandatory merger straight away. This step would have prevented panic and anxiety among GTB's depositors. Analysts also wondered why RBI rejected the proposal of equity injection from NewBridge, which would have solved the recapitalization problem of GTB easily and could have prevented the bank's eventual collapse. They wondered why RBI favoured the merger with OBC and did not try for competitive bidding to acquire GTB. Moreover, though the interests of

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GTB's depositors were protected, its shareholders lost their total investments in the bank overnight.

Questions

1. How financial mismanagement can lead to significant losses for a bank.
2. Analyze the reasons that led to the fall of Global Trust Bank
3. Discuss the importance of proper supervision and control systems in a bank to mitigate risks.
4. How overexposure to capital markets can lead to huge NPAs for a bank?
5. Write down the need for financial institutions to uphold the ideals of transparency and absolute scrupulousness where public money was involved.
6. Examine the role of RBI as a regulating authority and debating on the justifiability of its actions in the GTB fiasco.

Source: http://www.icmrindia.org/casestudies/

1.5 Summary

- Banks are institution whose debts usually referred to as bank deposits are commonly accepted in final settlement of other people's debts.
- A banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current accounts.
- Money and credit provide the pivot (axle) around which all the economic activities revolve.
- Banks are reservoirs of resources for economic growth and development of the nation.
- The Indian financial system is identified with two set of institutions viz. regulators and intermediaries.
- The commercial banking structure in India consists of two major set of players scheduled commercial banks and unscheduled banks.
- A bank accepts money from the people in the form of deposits.
- A bank provides easy payment and withdrawal facility to its customers in the form of cheques, drafts, ATM's, ETF.
- A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.
- The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks.
- The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment.

1.6 Keywords

Agency: A department or body providing a specific service for a government or similar organization.

Fiscal: Of or relating to government expenditures, revenues, and debt.

Notes

Foreign Exchange: The exchange of one currency for another or the conversion of one currency into another currency.

Loans: A thing that is borrowed, especially a sum of money that is expected to be paid back with interest.

NBFCs: Non-banking Financial Companies.

NBFIs: Non-banking Financial Intermediaries.

NBFSCs: Non- Banking Financial Services Companies.

Overdraft: A deficit in a bank account caused by drawing more money than the account holds.

Security: A financial instrument that represents: an ownership position in a publicly-traded corporation (stock), a creditor relationship with governmental body or a corporation (bond), or rights to ownership as represented by an option.

1.7 Review Questions

1. Explain the meaning of bank.
2. What is the origin of the word 'bank'?
3. Explain the characteristics of Indian Banking System.
4. What are the primary functions of commercial banks?
5. What do you understand by secondary functions of commercial banks?
6. Explain briefly the concept of discounting of bills.
7. Who performs the agency functions and briefly explain them?
8. What are the general utility services provided by commercial banks?
9. Why banks are considered as the heart of the financial system?
10. What are the two sets of institutions of Indian Banking System? Discuss in detail.

Answers: Self Assessment

1.	Ancient	2.	Policies
3.	Lending	4.	Withdrawal
5.	Banking, financial	6.	Promotion
7.	False	8.	True
9.	True	10.	Securities
11.	Underwriting		

1.8 Further Readings

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Unit 2: Role of Banks in the Development of Economy

Notes

CONTENTS

Objectives

Introduction

2.1 Role of Banks

2.2 Role of Banks in Indian Economy

2.2.1 Role of Banks in a Developing Economy

2.3 Financial Inclusion

2.3.1 Financial Inclusion in India

2.3.2 Economic Growth – Role of Financial Inclusion

2.3.3 Steps taken by RBI to Promote Financial Inclusion

2.4 Summary

2.5 Keywords

2.6 Review Questions

2.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the role of banks in Indian economy
- Define financial inclusion
- Elaborate on economic growth in Indian scenario
- Explain the steps taken by RBI to promote financial inclusion

Introduction

In the previous unit, we dealt with the meaning and nature of banks and characteristics of Indian Banking System. The unit also discussed about the various functions of commercial banks. This unit will help you to understand the role of banks in Indian economy. The various section and sub section of this unit will also summarize the concept of financial inclusion. Banks play an important role in development of Indian economy. After liberalization, the banking industry underwent major changes. The economic reforms totally have changed the banking sector. RBI permitted new banks to be started in the private sector as per there commendation of Narasimham committee. The Indian banking industry was dominated by public sector banks. But now the situations have changed. New generation banks with used of technology and professional management has gained a reasonable position in the bank in industry.

Banks over the years have become a significant aspect of an economy. With the ongoing financial depression, the position of banks have become all the more important in the course of working of the money market and hence the economy of a nation. The banking sector forming apportions of the financial sector primarily works as a financial intermediary generating money supply.

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From the different macroeconomic models, banks have been found to be a part of the supply side of the economy. However, over time banks have transformed from merely money generating organizations to a multi tasking entity.

2.1 Role of Banks

A proper financial sector is of special importance for the economic growth of developing and underdeveloped countries. The commercial banking sector which forms one of the backbones of the financial sector should be well organized and efficient for the growth dynamics of a growing economy.

Caution No underdeveloped country can progress without first setting up a sound system of commercial banking.

The importance of a sound system of commercial banking for a developing country may be depicted as follows:

- ***Capital Formation:*** The rate of saving is generally low in an underdeveloped economy due to the existence of deep-rooted poverty among the people. Even the potential savings of the country cannot be realized due to lack of adequate banking facilities in the country. To mobilize dormant savings and to make them available to the entrepreneurs for productive purposes, the development of a sound system of commercial banking is essential for a developing economy.
- ***Monetization:*** An underdeveloped economy is characterized by the existence of a large no monetized sector, particularly, in the backward and inaccessible areas of the country.

Notes The existence of a non monetized sector is a hindrance in the economic development of the country.

The banks, by opening branches in rural and backward areas, can promote the process of monetization in the economy.

- ***Innovations:*** Innovations are an essential prerequisite for economic progress. These innovations are mostly financed by bank credit in the developed countries. But the entrepreneurs in underdeveloped countries cannot bring about these innovations for lack of bank credit in an adequate measure. The banks should, therefore, pay special attention to the financing of business innovations by providing adequate and cheap credit to entrepreneurs.
- ***Finance for Priority Sectors:*** The commercial banks in underdeveloped countries generally hesitate in extending financial accommodation to such sectors as agriculture and small scale industries, on account of the risks involved there in. They mostly extend credit to trade and commerce where the risk involved is far less. But for the development of these countries it is essential that the banks take risk in extending credit facilities to the priority sectors, such as agriculture and small scale industries.
- ***Provision for Medium and Long-term Finance:*** The commercial banks in underdeveloped countries invariably give loans and advances for a short period of time. They generally hesitate to extend medium and long term loans to businessmen. As is well known, the new business need medium and long term loans for their proper establishment.

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Notes The commercial banks should change their policies in favour of granting medium and long term accommodation to business and industry.

- ***Cheap Money Policy:*** The commercial banks in an underdeveloped economy should follow cheap money policy to stimulate economic activity or to meet the threat of business recession. In fact, cheap money policy is the only policy which can help promote the economic growth of an underdeveloped country. It is heartening to note that recently the commercial banks have reduced their lending interest rates considerably.
- ***Need for a Sound Banking System:*** A sound system of commercial banking is an essential prerequisite for the economic development of a backward country.

Self Assessment

Fill in the blanks:

1. The commercial banking sector which forms one of the …….. of the financial sector should be well organized and efficient for the growth dynamics of a growing economy.
2. The rate of saving is generally low in an …….. economy due to the existence of deep-rooted poverty among the people.
3. Innovations are mostly financed by bank credit in the …….. countries.
4. The ……. business need medium and long term loans for their proper establishment.

2.2 Role of Banks in Indian Economy

In India, as in many developing countries, the commercial banking sector has been the dominant element in the country's financial system. The sector has performed the key functions of providing liquidity and payment services to the real sector and has accounted for the bulk of the financial intermediation process. Besides institutionalizing savings, the banking sector has contributed to the process of economic development by serving as a major source of credit to households, government, and business and to weaker sectors of the economy like village and small-scale industries and agriculture. Over the years, over 30-40% of gross household savings has been in the form of bank deposits and around 60% of the assets of all financial institutions accounted for by commercial banks. An important landmark in the development of banking sector in recent years has been the initiation if reforms following the recommendations of the first Narasimham Committee on Financial System. In reviewing the strengths and weaknesses of these banks, the Committee suggested several measures to transform the Indian banking sector from a highly regulated to a more market oriented system and to enable it to compete effectively in an increasingly globalised environment. Many of the recommendations of the Committee especially those pertaining to interest rate, an institution of prudential regulation and transparent accounting norms were in line with banking policy reforms implemented by a host of developing countries since 1970s.

2.2.1 Role of Banks in a Developing Economy

Banks play a very useful and dynamic role in the economic life of every modern state. A study of the economic history of western country shows that without the evolution of commercial

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banks in the 18th and 19th centuries, the industrial revolution would not have taken place in Europe. The economic importance of commercial banks to the developing countries may be viewed thus:

1. Promoting capital formation
2. Encouraging innovation
3. Monetization
4. Influence economic activity
5. Facilitator of monetary policy

Above all view we can see in briefly, which is given below:

- ***Promoting Capital Formation:*** A developing economy needs a high rate of capital formation to accelerate the tempo of economic development, but the rate of capital formation depends upon the rate of saving. Unfortunately, in underdeveloped countries, saving is very low. Banks afford facilities for saving and thus encourage the habits of thrift and industry in the community.

Did u know? Banks mobilize the ideal and dormant capital of the country and make it available for productive purposes.

The significance of Development Finance Institutions or DFIs lies in their making available the means to utilize savings generated in the economy, thus helping in capital formation. Capital formation implies the diversion of the productive capacity of the economy to the making of capital goods which increases future productive capacity. The process of Capital formation involves three distinct but interdependent activities, viz., saving financial intermediation and investment. However, poor country/economy may be, there will be a need for institutions which allow such savings, as are currently forthcoming, to be invested conveniently and safely and which ensure that they are channelled into the most useful purposes. A well-developed financial structure will therefore aid in the collections and disbursements of investable funds and thereby contribute to the capital formation of the economy. Indian capital market although still considered to be underdeveloped has been recording impressive progress during the post-interdependence period.

- ***Encouraging Innovation:*** Innovation is another factor responsible for economic development. The entrepreneur in innovation is largely dependent on the manner in which bank credit is allocated and utilized in the process of economic growth. Bank credit enables entrepreneurs to innovate and invest, and thus uplift economic activity and progress.
- ***Monetization:*** Banks are the manufactures of money and they allow many to play its role freely in the economy. Banks monetize debts and also assist the backward subsistence sector of the rural economy by extending their branches in to the rural areas. They must be replaced by the modern commercial bank's branches.
- ***Influence Economic Activity:*** Banks are in a position to influence economic activity in a country by their influence on the rate interest. They can influence the rate of interest in the money market through its supply of funds. Banks may follow a cheap money policy with low interest rates which will tend to stimulate economic activity.
- ***Facilitator of Monetary Policy:*** Thus monetary policy of a country should be conductive to economic development. But a well-developed banking system is on essential

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precondition to the effective implementation of monetary policy. Underdeveloped countries cannot afford to ignore this fact.

Caution A fine, an efficient and comprehensive banking system is a crucial factor of the developmental process.

- ***Support to the Capital Market:*** The basic purpose of DFIs particularly in the context of a developing economy, is to accelerate the pace of economic development by increasing capital formation, inducing investors and entrepreneurs, sealing the leakages of material and human resources by careful allocation thereof, undertaking development activities, including promotion of industrial units to fill the gaps in the industrial structure and by ensuring that no healthy projects suffer for want of finance and/or technical services. Hence, the DFIs have to perform financial and development functions on finance functions, there is a provision of adequate term finance and in development functions there include providing of foreign currency loans, underwriting of shares and debentures of industrial concerns, direct subscription to equity and preference share capital, guaranteeing of deferred payments, conducting techno-economic surveys, market and investment research and rendering of technical and administrative guidance to the entrepreneurs.
- ***Rupee Loans:*** Rupee loans constitute more than 90 per cent of the total assistance sanctioned and disbursed. This speaks eloquently on DFI's obsession with term loans to the neglect of other forms of assistance which are equally important. Term loans unsupplemented by other forms of assistance had naturally put the borrowers, most of whom are small entrepreneurs, on to a heavy burden of debt-servicing. Since term finance is just one of the inputs but not everything for the entrepreneurs, they had to search for other sources and their abortive efforts to secure other forms of assistance led to sickness in industrial units in many cases.
- ***Foreign Currency Loans:*** Foreign currency loans are meant for setting up of new industrial projects as also for expansion, diversification, modernization or renovation of existing units in cases where a portion of the loan was for financing import of equipment from abroad and/or technical know-how, in special cases.
- ***Subscription to Debentures and Guarantees:*** Regarding guarantees, it is well-known that when an entrepreneur purchases some machinery or fixed assets or capital goods on credit, the supplier usually asks him to furnish some guarantee to ensure payment of installments by the purchaser at regular intervals. In such a case, DFIs can act as guarantors for prompt of installments to the supplier of such machinery or capital under a scheme called 'Deferred Payments Guarantee'.
- ***Assistance to Backward Areas:*** Operations of DFI's in India have been primarily guided by priorities as spelt out in the Five-Year Plans. This is reflected in the lending portfolio and pattern of financial assistance of development financial institutions under different schemes of financing. Institutional finance to projects in backward areas is extended on concessional terms.

Example: Lower interest rate, longer moratorium period, extended repayment schedule and relaxed norms in respect of promoters' contribution and debt-equity ratio.

Such concessions are extended on a graded scale to units in industrially backward districts, classified into the three categories of A, B and C depending upon the degree of their backwardness. Besides, institutions have introduced schemes for extending term loans for project/area-specific infrastructure development. Moreover, in recent years, development

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banks in India have launched special programmes for intensive development of industrially least developed areas, commonly referred to as the No-industry Districts (NID's) which do not have any large-scale or medium-scale industrial project. Institutions have initiated industrial potential surveys in these areas.

- ***Promotion of New Entrepreneurs:*** Development banks in India have also achieved a remarkable success in creating a new class of entrepreneurs and spreading the industrial culture to newer areas and weaker sections of the society. Special capital and seed Capital schemes have been introduced to provide equity type of assistance to new and technically skilled entrepreneurs who lack financial resources of their own even to provide promoter's contribution in view of long-term benefits to the society from the emergence of a new class of entrepreneurs. Development banks have been actively involved in the entrepreneurship development programmes and in establishing a set of institutions which identify and train potential entrepreneurs.

  Again, to make available a package of services encompassing preparation of feasibility of reports, project reports, technical and management consultancy, etc. at a reasonable cost, institutions have sponsored a chain of 16 Technical Consultancy organizations covering practically the entire country. Promotional and development functions are as important to institutions as the financing role. The promotional activities like carrying out industrial potential surveys, identification of potential entrepreneurs, conducting entrepreneurship development programmes and providing technical consultancy services have contributed in a significant manner to the process of industrialization and effective utilization of industrial finance by industry. IDBI has created a special technical assistance fund to support its various promotional activities. Over the years, the scope of promotional activities has expanded to include programmes for up gradation of skill of State level development banks and other industrial promotion agencies, conducting special studies on important issues concerning industrial development, encouraging voluntary agencies in implementing their programmes for the uplift of rural areas, village an cottage industries, artisans and other weaker sections of the society.

- ***Impact on Corporate Culture:*** The project appraisal and follow-up of assisted projects by institutions through various instruments, such as project monitoring and report of nominee directors on the Boards of directors of assisted units, have been mutually rewarding. Through monitoring of assisted projects, the institutions have been able to better appreciate the problems faced by industrial units. It also has been possible for the corporate managements to recognize the fact that interests of the assisted units and those of institutions do not conflict but coincide. Over the years, institutions have succeeded in infusing a sense of constructive partnership with the corporate sector. Institutions have been going through a continuous process of learning by doing and are effecting improvements in their systems and procedures on the basis of their cumulative experience.

  The promoters of industrial projects now develop ideas into specific projects more carefully and prepare project reports more systematically. Institutions insist on more critical evaluation of technical feasibility demand factors, marketing strategies and project location and on application of modern techniques of discounted cash flow, internal rate of return, economic rate of return etc., in assessing the prospects of a project. This has produced a favourable impact on the process of decision-making in the corporate seeking financial assistance from institutions. In fact, such impact is not continued to projects assisted by them but also spreads over to projects financed by the corporate sector on its own.

  The association of institutions in the management of corporate bodies has considerably facilitated the process of progressive professionalism of the corporate management. Institutions have been able to convince the corporate managements to appropriately reorient their organizational structure, personal policies and planning and control systems.

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In many cases, institutions have successfully inducted experts on the Boards of assisted companies. As part of their project follow-up work and through their nominee directors, institutions have also been able to bring about progressive adoption of modern management techniques, such as corporate planning and performance budgeting in the assisted units. The progressive professionalism of industrial management in India reflects one of the major qualitative changes brought about by the institutions.

Task Search in your area and find out new entrepreneurs promoted by banks and write an article on the services provided by banks to such entrepreneurs.

Self Assessment

Fill in the blanks:

5. Banks play a very useful and …….. role in the economic life of every modern state.
6. Capital formation implies the diversion of the …… capacity of the economy to the making of capital goods which increases future productive capacity.
7. Bank credit enables entrepreneurs to …… and …….
8. ……. capital and …… capital schemes have been introduced to provide equity type of assistance to new and technically skilled entrepreneurs who lack financial resources of their own.
9. Promotional and development functions are as important to institutions as the ……. .

2.3 Financial Inclusion

Financial inclusion or inclusive financing is the delivery of financial services, at affordable costs, to sections of disadvantaged and low income segments of society. Unrestrained access to public goods and services is the sine qua non of an open and efficient society. It is argued that as banking services are in the nature of public good; the availability of banking and payment services to the entire population without discrimination is the prime objective of this public policy. The term "financial inclusion" has gained importance since the early 2000s, and is a result of findings about financial exclusion and its direct correlation to poverty.

2.3.1 Financial Inclusion in India

The Reserve Bank of India (RBI), which became an official member institution of the Alliance for Financial Inclusion in 2012, set up the Khan Commission in 2004 to look into financial inclusion and the recommendations of the commission were incorporated into the mid-term review of the policy (2005–06). In the report RBI exhorted the banks with a view of achieving greater financial inclusion to make available a basic "no-frills" banking account. In India, financial inclusion first featured in 2005, when it was introduced by K C Chakraborthy, the chairman of Indian Bank. Mangalam Village became the first village in India where all households were provided banking facilities. Norms were relaxed for people intending to open accounts with annual deposits of less than ₹ 50,000.

General Credit Cards (GCCs) were issued to the poor and the disadvantaged with a view to help them access easy credit. In January 2006, the Reserve Bank permitted commercial banks to make use of the services of Non-governmental Organizations (NGOs/SHGs), micro-finance institutions,

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and other civil society organizations as intermediaries for providing financial and banking services. These intermediaries could be used as business facilitators or business correspondents by commercial banks. The period of economic reforms has witnessed the key catalytic role played by banks in the achievement of high growth in the Indian economy. While the benefits of growth due to reforms, have concentrated in the hands of those already served by the formal financial system, a large section of the rural poor still does not have access to the formal banking channel. Further, the backward regions of the country, too, lack basic financial infrastructure.

Notes An essential prerequisite for inclusive and sustainable growth is capital formation through credit and financial services.

Therefore, access to a well-functioning financial system, by creating equal opportunities, enables economically and socially excluded people to integrate better into the economy, so as to actively contribute to development and protect themselves against economic shocks (RBI, 2008). The bank asked the commercial banks in different regions to start a 100% financial inclusion campaign on a pilot basis. As a result of the campaign, states or union territories like Puducherry, Himachal Pradesh and Kerala announced 100% financial inclusion in all their districts. Reserve Bank of India's vision for 2020 is to open nearly 600 million new customers' accounts and service them through a variety of channels by leveraging on IT. However, illiteracy and the low income savings and lack of bank branches in rural areas continue to be a roadblock to financial inclusion in many states and there is inadequate legal and financial structure.

The Reserve Bank of India (RBI) has, therefore, formulated the policy of financial inclusion with a view to provide banking services at an affordable cost to the disadvantaged and low-income groups. The RBI has observed that out of 600,000 habitations in the country, only about 5 percent have a commercial bank branch. Also only about 57 percent of the population across the country has bank account (savings), and this ratio is much lower in the North-Eastern states. Further, 13 percent of the population has debit cards and 2 percent has credit cards. India has a significantly low level of financial penetration compared with OECD countries (RBI, 2010). Further, while the access to bank branches in India fares better than that of China and Indonesia it is worse off when compared with Malaysia and Thailand. However, in terms of financial access through ATMs, India fares poorly compared to select Asian peer group countries (RBI, 2010). In view of the poor level of financial inclusion in India, RBI has accorded topmost policy priority to financial inclusion, by advising commercial banks, to formulate specific Board approved Financial Inclusion Plans (FIP) and to act on them on a mission mode. Banks were also advised by RBI to provide banking services in every village having a population of over 2000 by 31st March 2012, through bank branches as well as through various ICT-based models including through Business Correspondents (BCs).

In India, RBI has initiated several measures to achieve greater financial inclusion, such as facilitating no-frills accounts and GCCs for small deposits and credit. Some of these steps are:

1. ***Opening of no-frills accounts:*** Basic banking no-frills account is with nil or very low minimum balance as well as charges that make such accounts accessible to vast sections of the population. Banks have been advised to provide small overdrafts in such accounts.

2. ***Relaxation on know-your-customer (KYC) norms:*** KYC requirements for opening bank accounts were relaxed for small accounts in August 2005; thereby simplifying procedures by stipulating that introduction by an account holder who has been subjected to the full KYC drill would suffice for opening such accounts. The banks were also permitted to take any evidence as to the identity and address of the customer to their satisfaction. It has now

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been further relaxed to include the letters issued by the Unique Identification Authority of India containing details of name, address and Aadhaar number.

3. ***Engaging Business Correspondents (BCs):*** In January 2006, RBI permitted banks to engage Business Facilitators (BFs) and BCs as intermediaries for providing financial and banking services. The BC model allows banks to provide doorstep delivery of services, especially cash in-cash out transactions, thus addressing the last-mile problem. The list of eligible individuals and entities that can be engaged as BCs is being widened from time to time. With effect from September 2010, for-profit companies have also been allowed to be engaged as BCs. India map of Financial Inclusion by MIX provides more insights on this.

4. ***Use of technology:*** Recognizing that technology has the potential to address the issues of outreach and credit delivery in rural and remote areas in a viable manner, banks have been advised to make effective use of Information and Communications Technology (ICT), to provide doorstep banking services through the BC model where the accounts can be operated by even illiterate customers by using biometrics, thus ensuring the security of transactions and enhancing confidence in the banking system.

5. ***Adoption of EBT:*** Banks have been advised to implement EBT by leveraging ICT-based banking through BCs to transfer social benefits electronically to the bank account of the beneficiary and deliver government benefits to the doorstep of the beneficiary, thus reducing dependence on cash and lowering transaction costs.

6. ***GCC:*** With a view to helping the poor and the disadvantaged with access to easy credit, banks have been asked to consider introduction of a general purpose credit card facility up to ₹ 25,000 at their rural and semi-urban branches. The objective of the scheme is to provide hassle-free credit to banks' customers based on the assessment of cash flow without insistence on security, purpose or end use of the credit. This is in the nature of revolving credit entitling the holder to withdraw up to the limit sanctioned.

7. ***Simplified branch authorization:*** To address the issue of uneven spread of bank branches, in December 2009, domestic scheduled commercial banks were permitted to freely open branches in tier III to tier VI centres with a population of less than 50,000 under general permission, subject to reporting. In the north-eastern states and Sikkim, domestic scheduled commercial banks can now open branches in rural, semi-urban and urban centres without the need to take permission from RBI in each case, subject to reporting.

8. ***Opening of branches in unbanked rural centres:*** To further step up the opening of branches in rural areas so as to improve banking penetration and financial inclusion rapidly, the need for the opening of more bricks and mortar branches, besides the use of BCs, was felt. Accordingly, banks have been mandated in the April monetary policy statement to allocate at least 25% of the total number of branches to be opened during a year to unbanked rural centres.

Transition from class banking to mass banking and increased customer focus is drastically changing the landscape of Indian banking. Expansion of retail banking has a lot of potential as retail assets are just 22% of the total banking assets and contribution of retail loans to GDP stands merely at 6% in India vis-à-vis 15% in China and 24% in Thailand. All banks in our survey weigh Cost effective credit delivery mechanisms (100%) as most important to the promotion of financial inclusion. This was followed by factors such as identifying needs and developing relevant financial products (75%), demographic knowledge and strong local relations (62.5%) and ensuring productive use and adequate returns on credit employed (43.75%) in decreasing levels of importance. In fact, India has an expanding middle class of 250 to 300 million people in need of varied banking services. While 60% of our population has access to banks, only 15% of them have loan accounts and an overwhelming 70% of farmers have no access to formal sources of credit, reflective of immense potential for the banking system.

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Caselet

Mobile Money can Boost Financial Inclusion

A new research funded by the SWIFT Institute has revealed that mobile money can help to promote financial inclusion and boost savings rates amongst remote communities.

The research, carried out by US-based Tufts University in rural communities in northern Ghana with little access to financial services, demonstrated that take-up of mobile money can be easily promoted and that use of mobile money services can help to encourage a savings culture.

A month into the research project, 10% of participants had used the service solely for money transfer; two and half months later, usage increased to 26% of households, with 86% of users receiving money transfers and 70% of users saving on their mobile phone.

In a release SWIFT, the financial messaging provider for more than 10,000 financial institutions and corporations in 212 countries and territories, said the results could provide a possible model for policy makers around the world to extend the reach of financial services.

"If mobile money services can help to improve financial inclusion in this way, they could offer a crucial mechanism through which to address a stubborn problem that continues to hinder economic development," the statement said.

In the remote areas of sub-Saharan Africa, less than 20% of the population has access to any type of formal financial institution, defined as a bank, microfinance institution or cooperative. Yet access to financial services is a key aspect of development, as credit and savings allow households to invest, save and respond to shocks. In Ghana, this figure rises to about 29% of the population, according to the World Bank.

Millison Narh, Second Deputy Governor of the Bank of Ghana, said: "Access to financial services is crucial to economic development. The findings of this research suggest that mobile money – something that is readily available – offer a possible model for extending the benefits of financial services to a much wider section of the community."

Typically, households in rural areas save 'informally' at home or with local collectors (called "susu", in Ghana), and often rely on remittances from migrants to urban areas. While these strategies are important risk-sharing mechanisms for such households, they are also vulnerable to risks, including theft, restricted access to funds, high fees, or high transaction costs.

The research demonstrated that mobile money offers a new potential mechanism for increasing the financial inclusion of the world's poor. First and foremost, since it can reduce the cost and increase the security of money transfers, mobile money can improve households' ability to share risk.

Beyond money transfers, mobile money can also be used to create a secure "pseudo-savings" account, where individuals can deposit smaller savings amounts for more immediate needs. As the "account" is password-protected, the mobile money savings channel could offer greater security than savings under the mattress and better access than offered by the annual "share out" of savings clubs.

Increased network coverage and mobile phone ownership, as well as a growing number of mobile money services in many developing countries, including Ghana, would be crucial to the success of any mobile money-based financial inclusion strategy.

Therefore, a key element of the research was a set of positive steps to reduce barriers to the adoption and usage of mobile money in Ghana. These included the provision of some

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mobile phones, access to a mobile money agent, and a sensitization campaign on mobile money. As a result of these simple interventions, the research found that rural populations' interest in adopting mobile money was extremely high.

Jenny Aker, Assistant Professor of Economics, the Fletcher School, Tufts University, said:

"*Whilst these early findings are limited, the research suggests that simple interventions to alleviate the barriers to mobile money adoption can help to encourage its use for receiving remittances and as a saving mechanism. If further research supports these conclusions, mobile money could be an important mechanism for promoting financial inclusion.*"

Peter Ware, Head of the SWIFT Institute, said:

"*This first working paper from the SWIFT Institute is a perfect example of what the Institute was set up to achieve. It demonstrates that we can be the catalyst to bring the SWIFT community and academics together to explore ideas and extend understanding. Research results could have positive ramifications for the financial industry and policy makers.*"

The SWIFT Institute was founded in April 2012, with the core objectives of extending understanding of the current practice and future needs in global financial services, fostering independent research by giving grants and access to research data.

Source: http://www.citifmonline.com/index.php?id=1.1285440

2.3.2 Economic Growth – Role of Financial Inclusion

While over the years, reform process has widely transformed the economic landscape of India. The benefits of economic growth have not equitably reached different parts of our society. The rural and agricultural sector, in particular, has not gained the desired momentum of growth and development. Further, within cities, the inequality is on the rise and demographic pressure is leading to growth of slums. Economic growth in India has to be inclusive in order to make it sustainable. Inclusiveness is an essential element in a democracy. If policies that bring about economic growth do not benefit the people in a wide and inclusive manner, they will not be sustainable. Equally, inclusive growth is essential to grow the market size, which alone will sustain growth momentum. Above all, inclusive growth is the only just and equitable way that any society can grow.

The Indian Scenario

In India, the Government and the RBI have been promoting the necessity of inclusive banking, and the banking sector, as a collective body, has been taking several initiatives in this regard. In regard to rural sector the available data depicts the exclusion obtaining in this sector. The Situation Assessment Survey of Farmers was conducted in the year 2003 which indicated that the rural households were at 147.90 million and out of it 89.35 million were farmer households. Data indicated that 51.4% of the farmer households were financially excluded.

Though banks have made significant strides in all areas of their performance, vast segments of population, particularly the underprivileged, are yet to be brought on to the canvas of banking services. It is in this context that all efforts are required to bring about financial inclusion and bring those segments of population into the mainstream of life. This would not only enable the banks to expand their market share but expand the overall market, in the process of tapping the Bottom of Pyramid (BoP) i.e. the customers from the lower income segments.

In the Draft Approach Paper to the Eleventh Five Year Plan, the Planning Commission has emphasized the need for faster and greater inclusive growth during the Eleventh Five Year Plan period. The Draft Approach paper has correctly identified that to achieve a higher, sustainable and equitable growth for the country, it would be imperative that domestic savings, particularly

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those from the households increase. Such savings would then need to be channelized to the productive sectors to attain the desired growth objectives.

ABC of Financial Inclusion

At this stage, however, emphasizing that Financial Inclusion rests on three pillars viz. access to financial services, affordability of such services and actual utilization of such services. Financial inclusion can be achieved only if all the three pillars show affirmative results. Thus, the ABC of financial inclusion is advice, banking and credit. It must also be noted that while for developing countries like India, generally the process of financial inclusion starts with opening of savings bank accounts. The process, at a later stage, must also incorporate credit facilities and other financial services such as insurance. Thus, promotion of financial inclusion would require holistic and coherent approach on the part of the banking industry as also the regulator (RBI) and the Government.

Opportunities in Financial Inclusion

As CK Prahalad has stated in his book "Fortune at the Bottom of the Pyramid", "the future lies with those companies who see the poor as their customers". Under the new paradigm, it is essential to develop policies with well-structured incentives. With greater competition and narrower spread, some banks have already gone in a big way to provide financing and banking services to micro enterprises and low income families, accompanied by an expansion of the frontier of the micro finance products; credit and debit cards, micro mortgages, agricultural loans, savings accounts, micro insurance and remittances as well as a number of informal mechanisms for assisting low income groups. This is a new market sector with major potential, which allows for portfolio risk diversification and involves a massive and stable customer base.

2.3.3 Steps taken by RBI to Promote Financial Inclusion

RBI in its annual policy statement of April 2005 recognized the problem of Financial Exclusion and has initiated several policies, with a view to promote financial inclusion. The RBI has also formulated two models namely, business facilitator model, and business correspondent model to promote inclusive concept in banking sector.

Business Facilitator Model

Under this model, banks are now permitted to enlist the services of intermediaries.

Example: NGOs/Farmers Clubs, Cooperatives, Community-based organizations; IT enabled rural outlets of corporate entities, post offices, insurance agents, well functioning panchayats, and village knowledge centres etc.

The services that can be extended under this model include: Identification of borrowers and activities, collection and preliminary processing of loan applications including data verification, creating awareness about savings and other products, counselling on investment and money matters, processing and submission of applications to banks, promotion and nurturing of self-help groups/joint liability groups, post sanction monitoring, follow up of recovery etc.

Business Correspondent Model

Under this model, NGOs/MFIs set up under societies/trust act, societies registered under Mutually Aided Cooperative Societies Acts or the Cooperative Societies Acts of the states, Section 25

Notes

Companies, registered NBFCs not accepting public deposits and post offices may act as business correspondents. Banks may conduct thorough due diligence on such entities to establish their suitability. Business correspondents are permitted to take up all the activities listed for business facilitators. Additionally they may be engaged for: Disbursal of small value credit, recovery of principal/collection of interest, collection of small value deposits, sale of micro-insurance, mutual fund products, and pension products etc., receipt and delivery of small value remittances/ other payment instruments. Banks are permitted to pay reasonable commission to the business facilitators/correspondents. RBI has also advised the banks to safeguard against the legal and operational risks while engaging their services. They have to put in place a Grievance Redressal Machinery for redressing complaints about services rendered by business correspondents and facilitators.

Self Assessment

Fill in the blanks:

10. The period of economic reforms has witnessed the key …… role played by banks in the achievement of high growth in the Indian economy.
11. Banks have been advised to provide small …… in no-frills accounts.
12. Business correspondents are permitted to take up all the activities listed for business …….
13. The Situation Assessment Survey of Farmers was conducted in the year ……
14. They have to put in place a …… machinery for redressing complaints.
15. In India, financial inclusion was introduced by ……
16. In January 2006, RBI permitted banks to engage …… and …… as intermediaries for providing financial and banking services

Case Study

Financial Inclusion – A Huge Challenge

The RBI in its second quarter review of the monetary policy 2012-13 has mandated the State Level Bankers' Committees (SLBCs) to prepare a roadmap for provision of banking services in all unbanked villages with less than 2,000 people in a time bound manner. "Moving towards universal financial inclusion has been a national commitment," the RBI has emphasized in its report. The Financial Inclusion Advisory Committee chaired by Dr K C Chakrabarty will explore viable, affordable and sustainable banking service delivery models for unbanked population and suggest appropriate regulatory framework to stabilise financial inclusion.

Over the years, banks have introduced many innovations: ATMs, kissan credit cards, general credit cards, freedom prepaid cards, biometric cards, phone banking, mobile banking, electronic clearance services and banking correspondence to achieve financial inclusion.

Access to Credit

Over the last two decades India has witnessed the world's biggest micro credit movement in the world. As on March 31, 2012, nearly 86 lakh SHGs have been bank-linked. So nearly 17.20 crore people get access to banks' credit to start hundreds of small economic activities:

Contd...

Notes

Achar, masala, jelly, jam, papad, herbal medicines, handicrafts, handloom items and different kinds of eatables etc. The RBI has further asked banks to open zero balance savings bank account with ATM cum debit card facility so that all kinds of wages, subsidy and bank credit could be routed through bank accounts.

The Union government had allocated ₹ 50 crore in 2011-12 budget for banks to meet the expenditure towards opening zero balance accounts. As per the RBI report, banks have covered 74,199 unbanked villages by March 2012 out of the target of 74,414 villages.

Now the RBI is out to cover all unbanked villages across the country. Both public and private sector banks have set self targets of opening rural brick and mortar branches to cover unbanked villages. The number of brick and mortar branches has increased from 21,475 in March 2010 to 1,11,948 by March 2012. The number of no frills accounts has increased to 99 million by March 2012.

Over the decades, 31 state cooperative banks with their 371 DCCBs and nearly one lakh cooperative society outlets have been recapitalised and rescued from bad financial state from time to time in order to meet the unbanked population. Besides, many micro finance institutions have rolled their money to reach the unbanked population in the last decade.

In spite of a series of efforts, financial inclusion has not yielded the desired result because it is more a metabolic growth than a time bound programme which needs proper environment to take its root. In fact, the purpose of financial inclusion is to activate the micro credit cycle which ultimately helps borrowers to earn surplus after meeting their consumption need.

Banks, extension departments, people's representatives, NGOs and civil society have the joint responsibility to create credit absorption capacity among people. The rise in the price of sugar has made sugarcane replace pulses and other crops in Kolhapur district. Initially, the farmers got surplus income. But their joy turned in to frustration when the thirsty canes needed more water and the cost of inputs increased. The surplus eroded when farmers had to buy food grains at a higher cost from the market.

Clay models made by the artisans of Cuttack have high demand in different studios and in puja pendals across the country. In the absence of marketing facilities, credit flow can only become a bad loan. In pilgrim centre of Puri, people have the indigenous skill to make mouth watering sweet items from milk and ghee. If those items are not marketed, bank credit will become a burden on the producers. Pure cow ghee has huge demand all over the world for its medicinal, nutritional and religious value. Today one can find tonnes of adulterated cow ghee packs even in big malls. Agro processed food items have suffered huge credibility loss because there is nobody to authenticate quality. Credibility loss always affects bulk of the business.

Unless the producers at the bottom of the pyramid are left with surplus they cannot help consumer driven economy. For instance, in 2005, the cost of a flat in a prime area in Pune was ₹ 2,000 per sq feet. In 2012, the cost rose to ₹ 12,000 per sq feet after 100 per cent FDI in realty sector was allowed. Consumers are left with little surplus after meeting the basic necessities of life. Aadhaar card based cash transfer may aggravate the agriculture labour shortage in the country and make food costlier. There is need for scientific approach to address poverty through financial inclusion.

Questions

1. What innovations are done by banks over the past few years?
2. When will the bank credit become burden on the producers of several products?
3. How does loss of credibility affect the business?

Source: http://www.deccanherald.com/content/302794/financial-inclusion-huge-challenge.html

Notes

2.4 Summary

- The Banking sector, as the most important financial intermediary for mobilization of savings leading to investments towards growth, would thus, play the most crucial role in attaining the economic objectives of the country.
- Economic growth can be attained only by making banking more inclusive through expanding the coverage of banking services by reaching the vast unbanked and under-banked population of the country.
- Inclusive banking is not an end in itself but also a means to achieve balanced, sustainable and inclusive growth.
- The Reserve Bank of India (RBI), which became an official member institution of the Alliance for Financial Inclusion in 2012, set up the Khan Commission in 2004 to look into financial inclusion and the recommendations of the commission were incorporated into the mid-term review of the policy (2005–06).
- In India, financial inclusion first featured in 2005, when it was introduced by K C Chakraborthy, the chairman of Indian Bank.
- Basic banking no-frills account is with nil or very low minimum balance as well as charges that make such accounts accessible to vast sections of the population. Banks have been advised to provide small overdrafts in such accounts.
- The BC model allows banks to provide doorstep delivery of services, especially cash in-cash out transactions, thus addressing the last-mile problem.
- Economic growth in India has to be inclusive in order to make it sustainable. Inclusiveness is an essential element in a democracy. If policies that bring about economic growth do not benefit the people in a wide and inclusive manner, they will not be sustainable.
- In India, the Government and the RBI have been promoting the necessity of inclusive banking, and the banking sector, as a collective body, has been taking several initiatives in this regard. In regard to rural sector the available data depicts the exclusion obtaining in this sector.
- Banks have to put in place a Grievance Redressal Machinery for redressing complaints about services rendered by business correspondents and facilitators.

2.5 Keywords

Business Correspondents: Business correspondence is the exchange of information in written form for the process of business activities.

Cheap Money Policy: A monetary policy in which a central bank sets low interest rates so that credit is easily attainable.

Development Finance Institutions: A financial agencies that provide medium and long-term financial assistance and engaged in promotion and development of industry, agriculture and other key sectors.

Financial Inclusion: Financial inclusion or inclusive financing is the delivery of financial services, at affordable costs, to sections of disadvantaged and low income segments of society.

Monetization: Monetization is the process of converting or establishing something into legal tender.

Notes

2.6 Review Questions

1. What is the role of banks in a developing economy?
2. Explain the role of banks in Indian economy.
3. Discuss the concept of financial inclusion.
4. Explain, in detail, the financial inclusion in India.
5. Write short note on monetization.
6. What are the steps taken by RBI to achieve greater financial inclusion?
7. What is the role of financial inclusion in economic growth in Indian scenario?
8. What do you mean by ABC of financial inclusion?
9. Explain business facilitator model.
10. Discuss business correspondent model.

Answers: Self Assessment

1.	Backbones	2.	Underdeveloped
3.	Developed	4.	New
5.	Dynamic	6.	Productive
7.	Innovate, invest	8.	Special; seed
9.	financing role	10.	Catalytic
11.	Overdrafts	12.	Facilitators
13.	2003	14.	Grievance Redressal

15. K C Chakraborthy
16. business facilitators and business coordinators.

2.7 Further Readings

Books

Hajols. T. N (2009), "*Money and Banking*", Gopaljee Enterprises.

Muraleedharan, D (2009), "*Modern Banking: Theory and Practice*", PHI Learning Pvt. Ltd.

Rajesh, R, Sivagnanansithi, T (2009), "*Banking Theory: Law and Practice*", Tata McGraw Hill Publishing Company Ltd.

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Notes

Online links

http://www.iibf.org.in/scripts/iib_financeinclusion.asp

http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/FICHI121011S.pdf

http://www.scribd.com/doc/21923483/ROLE-OF-BANKS-IN-INDIAN-ECONOMY

http://www.one97.com/blog/2012/12/26/digital-financial-inclusion-in-india-present-and-future-amit-lakhotia-and-prerna-kalra-team-paytm/

Notes

Unit 3: Indian Banking System

CONTENTS

Objectives
Introduction
3.1 History
3.2 Classification of Banks in India
3.2.1 State Bank Group (Eight Banks)
3.2.2 Nationalized Banks (19 Banks)
3.2.3 Regional Rural Banks (RRBs)
3.2.4 Private Banks
3.2.5 Cooperative Banks
3.3 Present Scenario of Banking System in India
3.4 Reserve Bank of India: Role and Functions
3.4.1 Role of RBI
3.4.2 Functions of RBI
3.5 Techniques of Credit Control
3.5.1 Quantitative or General Methods
3.5.2 Qualitative or Selective Methods
3.6 Summary
3.7 Keywords
3.8 Review Questions
3.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the history of Indian banking system
- Classify Banks of India
- Elaborate on the present scenario of banking system in India
- Discuss the role and functions of RBI
- Explain the techniques of credit control

Introduction

In the previous unit, you have studied the role of banks in the development of an economy. To continue on, you will study Indian Banking System in this Unit. Without a healthy and efficient system of banking, India can not have a healthy economy. The Indian Banking System should not only be tussle free but it should be capable to cope with new threats posed by the technology and any other intrinsic and extrinsic factors. For the last three decades banking system of India has several striking accomplishments to its credit. The most outstanding is its broad reach. The

banking system of India is no more confined to urbanites or cosmopolites of India but it has arrived even to the distant niches of the country.

3.1 History

The word 'Bank' is said to be derived from French word "Bancus" or "Banque", i.e., a bench. It is believed that the early bankers, the Jews Lombardy, transacted their business on benches in the Market place. Others believe that it is derived from German word "Back" meaning a Joint Stock Fund.

The Modern banking System started with the opening of Bank of England in 1964. Bank of Hindustan was the first bank to be established in India in 1770. The earliest institutions that undertook banking business under the British regime were agency houses which carried on banking business in addition to their trading activities. Most of these agency houses were closed down during 1929-32. Three Presidency banks known as Bank of Bengal, Bank of Bombay and Bank of Madras were open in 1809, 1840 and 1843 respectively at Calcutta, Bombay and Madras. These were later merged in to Imperial Bank of India in 1919 following a banking crisis.

The first bank of limited liability managed by Indians was Oudh Commercial Bank Started in 1881 earlier between 1865 and 1870, only one bank, the Allahabad Bank Ltd., was established. Subsequently the Punjab National Bank started in 1894 with its office at Anarkali Market in Lahore (now in Pakistan) Swadeshi movement, which started in 1906, prompted formation of a number of commercial banks such as the peoples Bank of India Ltd., the Central Bank of India, the Indian Bank Ltd. and the Bank of Baroda Ltd. Banking crisis between 1913-1917 witnessed the failure of 588 banks. The Banking companies (inspection Ordinance) came in January 1946 and the Banking companies (Restriction of Branches) Act was passed in February 1946. The Banking Companies Act was passed in February 1946 which was later, amended to be known as Banking Regulation Act, 1949.

Meanwhile, the RBI Act, 1934 was passed and the Reserve Bank of India became the first Central bank of the country w.e.f. 01.04.1935, it took over the Central Banking activities from the Imperial Bank of India. The RBI was nationalized on 1.1.1949. The Imperial Bank of India was partially nationalized to form State Bank of India in 1955. In 1959, subsidiaries of the SBI namely, State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra and State Bank of Travancore were established.

On July 19, 1969, the Govt. of India took over ownership and control of 14 major banks in the Country with deposits exceeding ₹ 50 crore each. Again on 15th April 1980, six more banks with Total time and demand liabilities exceeding ₹ 200 Crore were nationalised. On 1993, one of the nationalized banks namely New Bank of India was merged with another nationalized bank i.e. Punjab National Bank.

Self Assessment

Fill in the blanks:

1. The Imperial Bank of India was partially …….. to form State Bank of India in 1955.
2. The earliest institutions that undertook banking business under the British regime were …….. houses which carried on banking business in addition to their trading activities.
3. Banking Companies Act was passed in February 1946 which was later amended to be known as Banking …….. Act, 1949.
4. Banking crisis between 1913-1917 witnessed the failure of ……. banks.

Notes

3.2 Classification of Banks in India

The banking structure in India consists of a central bank, public sector banks and private sector banks. Banks can be classified on the basis of different criteria. The following figure indicates the banking structure:

A. ***Central Bank:*** The Reserve Bank of India is the Central Bank. It is fully owned by the government. It is governed by a central board and headed by a Governor, who is appointed by the Central Government. It issues guidelines for the functioning of all banks operating within the country.

B. ***Public Sector Banks:***

(a) The State Bank Group: the State Bank of India and its associate banks

(b) 20 other nationalized banks

(c) Regional rural banks: they are sponsored by public sector banks

C. ***Private Sector Banks:***

(a) Private Banks

(b) Foreign Banks Operating in India

(c) Scheduled Cooperative Banks

(d) Non-scheduled Banks

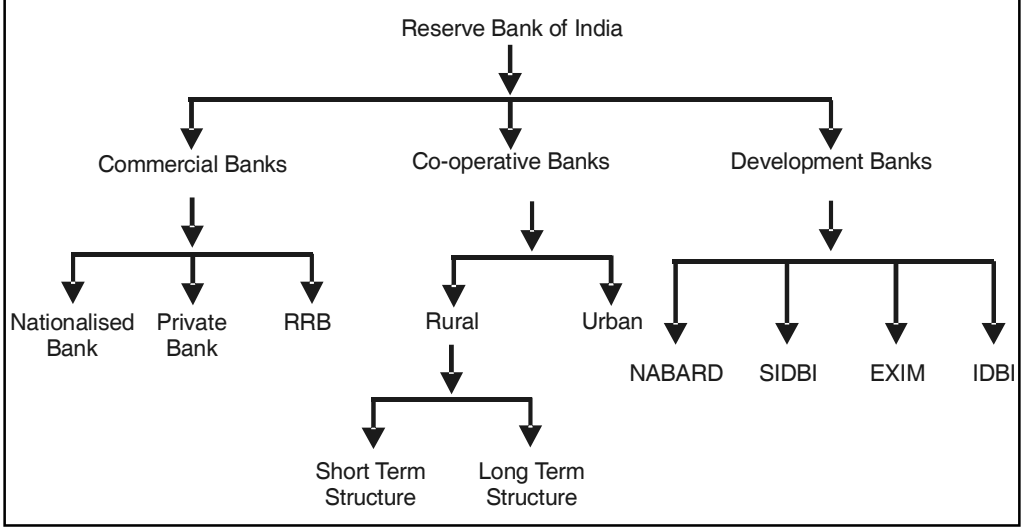
D. ***Cooperative Banks:*** The cooperative sector banks are related with rural areas and serve rural people mainly. The cooperative banking sector is divided into the following categories:

(a) State Cooperative Banks

(b) Central Cooperative Banks

(c) Primary Agriculture Credit Societies

Figure 3.1: Classification of Banks



Source: "Banking Operations"(2010),(P-07), Excel Books Pvt. Ltd.

Notes

Banks can be classified on the bases of different groups. Some of the important groups are explained below:

3.2.1 State Bank Group (Eight Banks)

This consists of the State Bank of India (SBI) and Associate Banks of SBI. The Reserve Bank of India (RBI) owns the majority share of SBI and some Associate Banks of SBI. SBI has 13 head offices governed each by a board of directors under the supervision of a central board. The boards of directors and their committees hold monthly meetings while the executive committee of each central board meets every week.

3.2.2 Nationalized Banks (19 Banks)

In 1969, the government arranged the nationalization of 14 scheduled commercial banks in order to expand the branch network, followed by six more in 1980. A merger reduced the number from 20 to 19. Nationalized banks are wholly owned by the Government, although some of them have made public issues. In contrast to the state bank group, nationalized banks are centrally governed, i.e., by their respective head offices. Thus, there is only one board for each nationalized bank and meetings are less frequent (generally, once a month). The state bank group and nationalized banks are together referred to as the Public Sector Banks (PSBs).

3.2.3 Regional Rural Banks (RRBs)

In 1975, the State Bank group and nationalized banks were required to sponsor and set up RRBs in partnership with individual states to provide low-cost financing and credit facilities to the rural masses.

3.2.4 Private Banks

Private banks have been playing a crucial role in enhancing customer oriented products with no choice left with the public sector banks except to innovate and compete in the process. Reserve Bank of India has come out on clear-cut terms, their guidelines on ownership and governance in private sector banks.

Major private banks in India are:

- Bank of Rajasthan
- Bharat Overseas Bank
- Catholic Syrian Bank
- Centurion Bank of Punjab
- Dhanalakshmi Bank
- Federal Bank
- HDFC Bank
- ICICI Bank
- IDBI Bank
- IndusInd Bank
- ING Vysya Bank

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- Jammu & Kashmir Bank
- Karnataka Bank
- Karur Vysya Bank
- Kotak Mahindra Bank
- SBI Commercial and International Bank
- South Indian Bank
- United Western Bank
- UTI Bank
- YES Bank

3.2.5 Cooperative Banks

Cooperative banks in India have come a long way since the enactment of the Agricultural Credit Cooperative Societies Act in 1904. It is an important instrument of banking access to the rural masses and is a vehicle for democratization of the Indian financial system.

The RBI regulates these banks since 1st March, 1966. In light of the liquidity and insolvency problems experienced by some cooperative banks in fiscal year 2001, the RBI undertook several interim measures to address the issues, pending formal legislative changes, including measures related to lending against shares, borrowings in the call market and term deposits placed with other urban cooperative banks.

Self Assessment

Fill in the blanks:

5. The cooperative sector banks are related with …… areas and serve …… people mainly.
6. The Reserve Bank of India (RBI) owns the ……. share of SBI and some Associate Banks of SBI.
7. There is only one board for each ……. bank and meetings are less frequent (generally, once a month).

3.3 Present Scenario of Banking System in India

The rate at which banking industry of India has shown an enormous growth over the last decade. When the whole world was on spin during the global financial crisis, banking sector of India has been able to maintain its elasticity providing growth opportunities simultaneously which is an unlikely feat to be compared to other developed markets of the world. The world economy has developed severe problems in terms of lapse of various banking and financial institutions and dipping demand in the recent times. Prospects became very unsure causing recession in major economies. However, amidst all this topsy-turvy India's banking sector has been amongst the few to maintain resilience. A progressively growing balance sheet, higher rate of credit expansion, expanding profitability and productivity akin to banks in developed markets, lower incidence of non-performing assets and focus on financial inclusion have contributed to making Indian banking vibrant and strong. Indian banks have commenced to revise their growth approach and reassess the prospects on hand to keep the economy wheeling.

Notes

The way forward for the banks of India is to innovate to take advantage of the new business opportunities and simultaneously ensure the continuous assessment of risks.

From traditional banking practices during the British Rule to reforms period, nationalization to privatisation and to the present trend of increasing number of foreign banks, Indian banking sector has undergone substantial transformation. The move from old to new business environment has created fresher demands on Indian banks like enhanced work flow, full access of customers to banking transactions through electronic mode etc. In the emerging scenario of cutthroat competition backed by parallel force of deregulation and technology, the degree of competition in the Indian financial Sector has increased to unprecedented level. Hence the functional efficiency of banks has achieved huge significance for their survival in the present scenario. In contrast to earlier 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning, modern outlook and tech-savvy methods of working for traditional banks has been ushered. All this has led to the retail boom in India. People are not just demanding more from their banks but also receiving more. With easy credit facilities the banks are transforming the consuming tendency of Indians with everything from microwave ovens to houses on sale at easy monthly installments EMIs.

Using information technology, banks have upgraded their systems to provide better customer services. Automatic Teller Machines (ATMs) dispensing any time money are visible in most localities of big cities and users are increasingly responding to banking transactions without visiting the banks. Online and mobile banking has brought the banks virtually to their doorsteps. However, all this has exposed the banks to new kinds of risks. The intimacy between bank employees and customers has become increasingly remote. Though the banks allot various back end and front end operations to minimize risk and use highly secures socket layers SSLs, digital certificates and facilities like virtual key boards to reduce the risks in online transactions, attacks like phishing and pharming have been hit up. Since the Lehman Brothers declared bankruptcy in 2008, incidences, every now & then, have sustained the concerns over global financial stability.

While most Emerging Market Economies (EMEs), including India, have healed from global financial crisis, advanced nations continue to be plagued with growth figures looking dismal. Euro zone crisis seems to be spreading across the EU countries following ripple effect, political turmoil persists in Middle East & North African (MENA) region, and economic stagnation in US forecasts no imminent respite from the worsening global situation. Indian banks, however, not only emerged unscathed from the global financial crisis but continued to manage growth with resilience during 2010-11. Presently, domestic demand stays restrained on account of slower pace of growth & high level of commodity prices but favourable demographics & growth potential of Indian economy are expected to mitigate the dampening effect in the long run. As per Census 2011, about 40 % of households still do not avail banking facilities. Banks with their forward looking strategies, improved customer relationship, diversification of revenue sources etc. are anticipated to continue their impressive performance. The idea of creating bigger banks to take on competition sounds attractive.

Notes It is crucial to note here that even the biggest banks amidst banks of India are small by global measures.

The lack of global scale for banks of India came into sharp focus during the recent financial crisis which saw various international banks reneging on their funding commitments to Indian companies, but local banks could not step into the breach because of balance sheet limitations. In this light, 93.75% of all respondents to our survey are considering expanding their operations in the future.

Notes

Did u know? There are two methods to meet bank's expansion needs:

Organic means of growth that comes out of an increase in the bank's own business activity, and Inorganic means that includes mergers or takeovers.

The last decade has seen many positive developments in the banking sector of India. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favourably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market evaluation. However, improved regulations, innovation, growth and value creation in the sector remain confined to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. The banking industry of India needs to make itself more stronger because it has to support the vibrant and modern economy that India aspires to be. An enabling policy and good regulatory framework will be very crucial for the success of management of bank with the burden of this change. Many developed countries have failed to react to the changing market realities and the same has stunted the development of their financial sectors. A weak banking structure could not enable itself to fuel its continued development that has harmed the long-run development of their economies.

Caution There is a need to act both decisively and quickly to build an enabling, rather than a limiting, banking sector in India.

Self Assessment

Fill in the blanks:

8. The idea of creating bigger banks to take on …… sounds attractive.
9. The …… between bank employees and customers has become increasingly remote.
10. The functional efficiency of banks has achieved huge ……..... for their survival in the present scenario.

3.4 Reserve Bank of India: Role and Functions

The Reserve Bank of India (RBI) was established on 1st April 1935 under the Reserve Bank of India Act, 1934. After its establishment, it took over the function of issuing paper currency from the Government of India and of controlling credit from the Imperial Bank of India. It originally started as a shareholders bank with a paid-up capital of ₹ 5 crores. It was nationalized on 1st January 1956 and since then it has been functioning as a State owned and State-controlled Central Bank.

3.4.1 Role of RBI

The Reserve Bank had a paid up capital of ₹ 5 crore divided into 5 lakh shares of ₹ 100 each. The Government of India owns all shares. The management is vested in the Central Board of Directors, which has twenty members as given below:

Notes

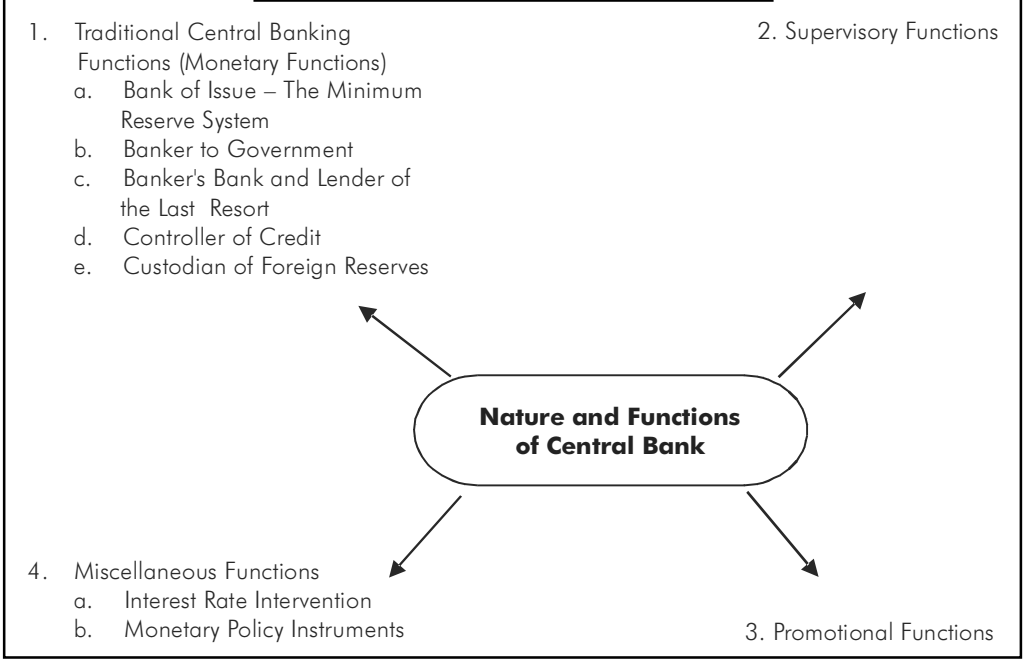
1. One Governor and four Deputy Governors appointed by the Government of India for a period of five years. Their salary, etc., are decided by the Central Board of Directors in consultation with the Government of India.
2. Four directors nominated from the local boards, located at Bombay (Mumbai), Calcutta (Kolkata), Madras (Chennai) and New Delhi by the Government of India. Their tenure is also five years.
3. Ten other directors nominated by the Government of India whose term is four years.
4. An official of the Government of India to attend the meetings of the Central Board. His tenure is not fixed and he does not enjoy the right to vote in the meetings.
5. The Central Board is required, under the Act, to meet at least six times a year. The Governor of the Reserve Bank can call the meeting of the Central Board, whenever he thinks necessary. Each local board has at least four members, appointed by the Government of India for a period of four years and representing all interests. The local boards render advice to the Central Board and also perform the various jobs assigned to them by the Central Board.

3.4.2 Functions of RBI

The Central Bank is the apex monetary institution in the money market. It acts as the monetary authority of the country and serves as the government bank as well as the bankers' bank. It undertakes the major financial operations of the government. It influences the behaviour of financial institutions to ensure that they support the economic policy of government.

The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems. For this purpose, the bank is given wide powers. Another important function of the central bank is to conduct the banking and financial operations of the government. Besides, it discharges certain other functions. These functions are performed with the service motive and not for making profits.

Figure 3.2: Role and Functions of Central Bank



Source: Gulati, Neelam C, "*Principles of Banking Management*", (2010), (P-61), Excel Books Pvt. Ltd.

Notes

Traditional Central Banking Functions (Monetary Functions)

Bank of Issue — The Minimum Reserve System

- The Reserve Bank has a separate Issue Department, which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the banking department.
- Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations.
- The Government of India makes one rupee notes and coins and small coins and RBI on its behalf, distributes all over the country as agent of the Government.
- Originally, the assets of the Issue Department consisted of not less than two-fifths of gold coin, gold bullion or securities, provided the amount of gold was not less than ₹ 40 crores in value.
- The remaining three-fifths of the assets might be in form of rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India.
- Due to the emergencies of the Second World War and the post-war period, these provisions were considerably modified.
- Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of ₹ 200 crores, of which at least ₹ 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

Banker to Government

Reserve Bank of India Acts as a government banker, agent and adviser.

- The Reserve Bank is an agent of Central Government and of all State Governments in India, except that of Jammu and Kashmir.
- The Reserve Bank has the obligation to transact government business, to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the government.
- Carry out government exchange remittances and other banking operations.
- The Reserve Bank of India helps the government — both the Union and the states to float new loans and to manage public debt.
- It makes Ways and Means Advances (WMA) to the governments for 90 days.
- It makes loans and advances to the states and local authorities.
- It acts as adviser to the government on all monetary and banking matters.

Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank:

- According to the provisions of the Banking Regulation Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2% of its time liabilities in India. By an amendment in 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3% of their aggregate deposit liabilities. The Reserve Bank of India can change the minimum cash requirements.

Notes

- Commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis; the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.
- The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities.
- Can get financial accommodation in times of need or strictness by rediscounting bills of exchange.

Controller of Credit

The Reserve Bank of India is the controller of credit. Some of its features are as follows:

- Through open market operations, a central bank influences the money supply in an economy directly.
- According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities.
- Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.
- Every bank has to get a license from the Reserve Bank of India to do banking business within India.
- The license can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch.
- Each scheduled bank must send a weekly report to the Reserve Bank showing, in detail, its assets and liabilities.
- The Reserve Bank has also the power to inspect the accounts of any commercial bank.
- These powers of the bank, to call for information, are also intended to give it effective control of the credit system.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange.

- According to the Reserve Bank of India Act, of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than ₹ 10,000. The rate of exchange fixed was ₹ 1 = sh. 6d. Since 1935, the Bank was able to maintain the exchange rate fixed at lsh. 6d. Though there were periods of extreme pressure in favour of or against the rupee.
- After India became a member of the International Monetary Fund in 1945, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the IMF.
- The Reserve Bank has to act as the custodian of India's reserve of international currencies i.e., forex balances are acquired and managed by the Bank.
- The RBI has the responsibility of administering the exchange controls of the country.

Thus, as a supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

- It holds the cash reserves of all the scheduled banks.
- It controls the credit operations of banks through quantitative and qualitative controls.

Notes

- It controls the banking system through the system of licensing, inspection and calling for information.
- It acts as the lender of the last resort by providing rediscounting facilities to scheduled banks.
- Controller of Forex Reserves of the country.
- In addition to its traditional central banking functions, the Reserve Bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India.

Supervisory Functions (Non-monetary Functions)

- The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers.
- The RBI has to supervise and control commercial and co-operative banks in relation to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation.
- The RBI is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them.
- The nationalization of 14 major Indian scheduled banks in July 1969 imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives.
- The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

Promotional Functions (Non-monetary Functions)

Since Independence, with economic growth, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking.

1. The Reserve Bank promotes the banking habit.
2. Extends banking facilities to rural and semi-urban areas.
3. Establishes and promotes new specialized financing agencies i.e., Industrial Development Banks.
4. Development of the co-operative credit movement to encourage savings and to eliminate moneylenders from the villages and to route its short-term credit to agriculture.

Example: Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

Miscellaneous Functions

Following are the miscellaneous functions of RBI:

Interest Rate Interventions: The most visible and obvious power of many modern central banks is to influence market interest rates; contrary to popular belief, they rarely 'set' rates to a fixed

number. Typically, a central bank controls certain types of short-term interest rates. These influence the stock and bond markets as well as mortgage and other interest rates.

The mechanism to move the market towards a 'target rate' (whichever specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities, until the targeted market rate is sufficiently close to the target. Central banks may do so by lending money to and borrowing money from (taking deposits from) a limited number of qualified banks, or by purchasing and selling bonds.

Monetary Policy Instruments: The main monetary policy instruments available to central banks are open market operation, bank reserve requirement, interest-rate policy, re-lending and rediscount (including using the term repurchase market), and credit policy (often coordinated with trade policy).

Notes To enable open market operations, a central bank must hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves.

It will often have some influence over any official or mandated exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between (managed float or dirty float).

Through open market operations, a central bank influences the money supply in an economy directly. Each time it buys securities, exchanging money for the security, it raises the money supply. Opposite to this, selling of securities lowers the money supply. Buying of securities thus amounts to printing new money while lowering supply of the specific security.

The main open market operations are:

- Temporary lending of money for collateral securities (Reverse Operations or repurchase operations, otherwise known as the 'repo' market). These operations are carried out on a regular basis, where fixed maturity loans (of 1 week and 1 month for the ECB) are auctioned off.
- Buying or selling securities (Direct Operations) as per need.
- Foreign exchange operations such as forex swaps.

All of these interventions can also influence the foreign exchange market and thus the exchange rate.

Task Compare the functions of central banks of India and U.S.

Self Assessment

State whether the following statements are true or false:

11. A central bank controls certain types of long-term interest rates.
12. Through open market operations, a central bank influences the money supply in an economy directly.
13. Commercial banks can never expect the Reserve Bank of India to come to their help in times of banking crisis.
14. The Reserve Bank has to act as the custodian of India's reserve of international currencies.

Notes

3.5 Techniques of Credit Control

Several tools and techniques of credit control used by the Reserve Bank of India can be broadly categorized as quantitative or general methods and qualitative or selective methods.

3.5.1 Quantitative or General Methods

The tools used by the central bank to influence the volume of credit in totality in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods govern the lending power of the financial sector of the whole economy and do not discriminate among the several spheres of the economy. The crucial quantitative methods of credit control are:

- ***Bank Rate Policy:*** The standard rate at which the central bank is ready to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the provisions of the Act of RBI. Thus, the Reserve Bank of India rediscounts the first class bills in the hands of commercial banks to furnish them with liquidity in case of need.

  Caution Bank rate is subjected to change from time to time in accordance with the economic stability and its credibility of the nation.

  The bank rate indicates the central bank's long-term outlook on interest rates. If the bank rate moves up, long-term interest rates also tend to move up, and vice-versa.

  Banks make a profit by borrowing at a lower rate and lending the same money at a higher rate of interest. If the RBI hikes the bank rate (this is currently 6 per cent), the interest that a bank pays for borrowing money (banks borrow money either from each other or from the RBI) increases. It, in turn, raises its own lending rates to ensure it continues to make a profit.

- **Open Market Operations:** It means of enforcing monetary policy by which RBI controls the short term rate of interest and the supply of base money in an economy, and thus indirectly the total supply of money. In times of inflation, RBI sells securities to finish off the excess money in the market. Similarly, to increase the money supply, RBI purchases securities.

- ***Adjusting with CRR and SLR:*** By adjusting the CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) which are short term tools to be used to shortly govern the cash and fund flows in the hands of the banks, people and government, the central bank of India regularly make necessary alterations in these rates. These variations in the rates will easily have a larger control over the cash flow of the country.

  (i) *CRR (Cash Reserve Ratio):* All commercial banks are required to retain a certain amount of its deposits in cash with RBI. This percentage is called the cash reserve ratio. The present CRR requirement is 4 per cent. This serves two purposes. Firstly, it ensures that a part of bank deposits is totally risk-free and secondly it enables RBI to control liquidity in the system, and thereby, inflation by tying their hands in lending money

  (ii) *SLR (Statutory Liquidity Ratio):* Indian banks are required to maintain 25 per cent of their time and demand liabilities in government securities and certain approved securities. What SLR does is again restrict the bank's leverage in lifting more money into the economy by investing a part of their deposits in government securities as a part of their statutory liquidity ratio requirements.

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- ***Lending Rate:*** Lending rates can be defined as the ratios fixed by RBI to lend the money to the customers on the basis of those rates. The higher the rate of lending signifies the costlier credit to the customers. The lower the rate of lending signifies the credit to the customers is less which will encourage the customers to borrow funds from the banks more that will facilitate the flow of more money in the hands of public.
- ***Repo Rate:*** Repo rate is the rate at which banks borrow funds from the central bank to fill the gap between the demand they are facing for providing loans to their customers and how much funds they have on hand to lend.

  If the RBI wants to make it more costly for the banks to borrow money, it hikes the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it cuts the repo rate.
- ***Reverse Repo Rate:*** The rate at which Reserve Bank of India borrows money from the banks (or banks lend money to the RBI) is termed as the reverse repo rate. The RBI uses this instrument when it feels there is too much funds floating in the banking industry.

If the reverse repo rate is rising up, it means the RBI will borrow money from the bank and offer them a lucrative rate of interest. As a result, banks would prefer to keep their money with the RBI (which is absolutely risk free) in lieu of lending it out (this option comes with a certain amount of risk) to other customers.

Caselet

RBI Cuts Rates after 9-month Wait, Stays Cautious

The Reserve Bank of India (RBI) lowered its key policy rate for the first time in nine months on Tuesday, but struck a cautious note on further easing as it waits to see how the government's upcoming budget aims to bring a bloated fiscal deficit under control.

The RBI cut the policy repo rate by 25 basis points (bps) to 7.75 percent to help support an economy set to post its slowest annual growth rate in a decade.

The RBI revised its GDP growth forecast for Asia's third-largest economy to 5.5 percent from 5.8 percent for the fiscal year ending in March, a sharp come down for an economy that was running at near double-digit growth before the Lehman Brothers crisis.

Though respectable by other standards, the growth rate is too slow for an economy trying to support hundreds of millions of poor people, and is a worry for the ruling Congress party as it heads towards an election next year.

"It is now critical to arrest the loss of growth momentum without endangering external stability," the RBI said in its policy review.

But it went on to list constraints, notably worryingly high current account and fiscal deficits, and the risk that inflation could flare again.

Governor Duvvuri Subbarao told a news conference that if inflation and the current account deficit moderated by more than expected there would be room to ease monetary policy.

"The message that we are trying to give is that as much as there is some space, it going to be quite limited, and we are going to use it with a lot of judgment on timing and quantum," Subbarao said.

Source: http://in.reuters.com/article/2013/01/29/india-rbi-policy-review-repo-rates-idINDEE90R0GI20130129

Notes

3.5.2 Qualitative or Selective Methods

The tools used by RBI to govern the flows of credit into specific directions of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the types of credit extended by the commercial banks; they affect the composition of credit rather than the size of credit in the economy. The important qualitative or selective methods of credit control are:

- ***Marginal Requirements:*** Every commercial bank has to keep a margin whenever it provides loans against the security. It means that the amount of loan is lower than the real value of security.

Example: Actual value of security is 100 and the amount of loan is 85, therefore margin requirement is 15%.

Central bank can increase or decrease the supply of money by altering the requirements of margin.

Example: If central bank wants to decrease the money supply it can do so by increasing the margin requirements. In this way amount of loans decreases.

- ***Regulation of Consumer Credit:*** Consumer credit facility refers to the act of selling a consumer good on a credit basis to the customers. This tool is used by government or Reserve Bank of India to enforce certain regulations on the goods that are sold on credit. If the central bank wants to increase the money supply it can do so by adopting a lenient policy about the credit for purchase of consumer goods. Similarly central bank can cut the money supply by putting limitations on consumer credit.
- ***Credit Rationing:*** Central bank uses credit rationing to fix the credit ceiling allowed for each and every commercial bank.

Did u know? The central bank fixes the credit limit for each commercial bank and does not give credit to them beyond that limit.

Whenever the RBI desires to cut the supply of money, it decreases the limit up to which it can give loans to the member banks. Likewise, central bank can increase the money supply by increasing the credit limit.

- ***Moral Suasion:*** In some cases central bank morally persuades or requests the commercial banks not to get involved themselves in such economic activities which are unfavourable to the interest of the country. It regularly guides and proposes the member banks to follow a specific policy for loans and abstain themselves from giving loan for speculative purposes.
- ***Direct Action:*** Direct action is the last option through which central bank takes a direct action against the bank which does not act in conformity with the policy of Reserve Bank of India. In case of direct action the central bank can impose fine and penalty and can deny giving out loans to the commercial bank. Such type of force keeps commercial banks away from unsought credit activities.
- ***Publicity:*** Central bank also publishes details concerning its policies and important information about assets and liabilities, credit and business situation etc. of commercial banks. This facilitates commercial banks as well as general public to realize the monetary needs of country. Central bank discloses some of the important information about the

commercial banks so that the people know about the several activities of commercial banks and can protect themselves from any potential loss in the future.

Self Assessment

Fill in the blanks:

15. Direct action is the last option through which central bank takes a direct action against the bank which does not act in …….. with the policy of Reserve Bank of India.

16. This tool is used by government or Reserve Bank of India to enforce certain …….. on the goods that are sold on ……...

Case Study

Grameen Bank: The Grameen General Credit System

"Grameen Bank, one of the oldest micro-finance institutions in Bangladesh, is a good example of how the industry is changing and growing. In 2000, Grameen Bank began to consider how it could introduce greater client choice while ensuring credit discipline and controlling costs. This led to the emergence of Grameen II in 2002, offering deposit services to the general public, greatly expanding the range of deposit services offered to members, including the very popular 'Grameen Pension Savings'."

– Praful C. Patel, South Asia Regional Vice-President, The World Bank, in 2006

"Grameen General System (GGS) is not only a powerful and efficient system, capable of providing custom-made financial services to support the economic and social upliftment of each individual borrower family, but also it frees micro-credit from the usual stresses and strains."

– Prof. Muhammad Yunus, Founder and Managing Director of Grameen Bank, in 2002

The case explains Bangladesh based Grameen Bank's two microfinance models - Grameen Classic System and Grameen General System (GGS). For over two decades, Grameen Bank extended loans to poor people in Bangladesh under its Grameen Classic credit system. In 1998, the floods ravaged the country which led to many poor people default on their loan payments. This led to the need for a new, more flexible credit system. The result was Grameen General System which allowed the borrowers to remain as the member of the bank even when they were unable to pay their loan instalments. The case gives an overview of the GGS and the success Grameen Bank achieved after implementing the new credit system.

Saira Begum (Saira) became a member of Bangladesh-based Grameen Bank in 1994. With the loans given by Grameen Bank, she invested in dairy cattle, and with this investment, she earned regular income. When her outstanding loan was around Tk 5,000, Bangladesh was ravaged by floods. Saira Begum lost heavily and was deep in debts.

She received a top-up loan from the bank, which increased the burden of weekly instalments. Unable to repay the money she owed the bank, she stopped attending the mandatory weekly meetings of the bank, and she was not able to obtain any more loans. Later, the branch manager of Grameen Bank approached her and explained to her a new loan offering of the bank called flexi-loan, which required her to pay only Tk 25 a week as instalment - a smaller amount than her earlier instalment. Saira began paying the instalments regularly and repaid her entire loan. This made her eligible for a fresh loan, and using this loan she

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Notes

started a small shop. She had plans to send her school-going son to college using the education loan provided by Grameen Bank. Several women like Saira were able to improve their living conditions because of Grameen Bank, which provided them small loans. For over 25 years, Grameen Bank has been following the Grameen model of micro-credit, later renamed the Grameen Classic System (GCS) to extend loans to the poor in the country.

Though the system was successful, it was criticized for its standardized rules, which were strictly enforced. The GCS rules required a strict adherence to repayment schedules. Once poor borrowers failed to pay their instalments on time, they were not eligible for any further loans.

In order to address the drawbacks of GCS, Grameen Bank introduced a new credit system called Grameen General System (GGS) popularly known as Grameen II. Elaborating on the need for the new system, Muhammad nus (Yunus), Founder and Managing Director of Grameen Bank said, "The system (GCS) consisted of a set of well-defined standardized rules. No departure from these rules was allowed.

Once a borrower fell off the track, she found it very difficult to move back on, since the rules which allowed her to return, were not easy for her to fulfil. More and more borrowers fell off the track. Then there was the multiplier effect. If one borrower stopped payments, it encouraged others to follow." The changes were brought out in the form of new products, flexible loans and repayment schemes for borrowers who were unable to pay their loans on time, deposit services, pension services, etc.

The new system was completely demand driven; the products were tailored to the borrower's needs. The new flexible system allowed the borrowers to decide on the amount, term and payment schedule of the loan. GGS brought non-members into its fold by allowing them to deposit money and use other services.

Background Note

Yunus completed his PhD in Economics from Vanderbilt University in Nashville, Tennessee. He became the Head of Economics department in Chittagong University in Bangladesh. In 1971, Bangladesh got its independence. The country was hit by famine in 1974.

During this period, Yunus came face to face with the problems faced by poor women in Bangladesh when he visited Jorba village, where he saw poor women making bamboo stools. They were in the clutches of poverty and were forced to sell the products they made to moneylenders at very low prices. He extended a small loan of US$ 27 to US$ 42 to each of the women. They repaid the amount to the moneylenders and thus began the journey of Yunus and Bangladesh Grameen Bank.

When Yunus approached the banks in Bangladesh, asking them to lend loans to the poor, they were not willing to extend credit as the poor were not considered to be creditworthy and did not have any collateral to offer.

The Grameen Classic System

Organizing people into groups of five members each and bringing together a few such groups to form a centre was the keystone of GCS. Under the system, group liability replaced the collateral that was required by the banks to extend loans. The group had members from a homogeneous background, who knew each other, but were not related to each other. Six to ten such groups formed a centre and each village had one or two

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Notes

centres. A branch of Grameen Bank, with branch manager and employees covered 15 to 20 villages, with the covered area not exceeding 50 square kilometres.

Need for a New System

The floods that ravaged Bangladesh in 1998 devastated most of the country, and several places were submerged under water for over two months. The floods affected more than 1.2 million Grameen members and most of the borrowers were unable to repay their loans. The bank relaxed the terms of repayment and tried to help the borrowers rebuild their lives by providing additional loans. It was not long before the borrowers faced the burden of paying higher instalments, which was beyond their means. The repayment levels decreased and several borrowers stopped attending the weekly meetings. In order to cover the defaults, Grameen Bank obtained Tk 2 billion loan from the commercial banks and raised Tk 1 billion through bonds.

The Grameen II Credit System

One of the major changes that were brought through GGS was that the group liability system was discontinued and the individual liability system was adopted. The loan of each member was secured against her word. Against the previous practice of providing the loans to only two of the needy people in the group, the loans could be provided to all the members of the group. The first basic loan provided to the new members was Tk 5,000; fellow members could recommend for a higher or lower loan amount. The final decision on the amount to be disbursed was made by the Kendra Manager.

Basic and Flexi-Loans

GGS consisted of one prime loan product called the basic loan. It provided flexibility to design the loan according to the requirements of the borrower. The term of the loan could range from 3 months to 3 years. When the borrowers had developed their skills, commitment and discipline for conducting small businesses and expanding existing businesses, larger loans were provided. If the members were regular in repaying their basic loan, saving, and attending the weekly meetings regularly, they could opt for business expansion or special production loans. The borrowers were also allowed to prepay the instalments and loans.

Savings Account

Since its inception, Grameen Bank had maintained a group fund system. However, under GGS, the group fund and the group joint account were done away with and the borrowers were required to open two accounts, a personal savings account and special savings account.

When the loan was taken, 2.5% of the amount was deposited into the personal savings account. The borrowers were also required to deposit a minimum amount every week depending on the value of the loan taken. For loans upto Tk 15,000 the weekly savings was Tk 5 and for loans of Tk 100,000, the weekly saving was Tk 50.

The borrowers could also deposit more money if they wished to. The minimum deposit amount could also be determined for a centre in consultation with the Kendra Manager. Borrowers were free to withdraw money from the personal savings account at any point of time, provided they fulfilled the obligations related to the loan repayment schedule.

Other Products

Insurance: Another new concept introduced in GGS was loan insurance. According to this scheme, on the last day of the financial year, borrowers were required to deposit a small amount in loan insurance savings account.

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The amount to be deposited was equivalent to 3% of the total outstanding amount (loan and interest) on the last day of the year. If the outstanding amount was higher in the next year, 3% of the extra amount was to be deposited. In the event of the death of the borrower, the outstanding loan amount was paid by the insurance fund. The family of the deceased also received amount equal to the total savings in the borrower's insurance savings account.

Fixed Deposits: GGS also offered fixed deposit services to its members. Lump sum amounts deposited for one year were paid interest at 8.75% per annum in the year 2003. For a longer term, interest was paid at 9.5% for a period greater than one year.

Looking Ahead

The introduction of Grameen II had a positive impact on the membership and portfolio size of the bank. The number of active clients grew to over four million by 2004 and to 6.2 million by 2006 from 2.3 million in 2002. Due to the introduction of new savings products, deposits grew from US$ 163 million in 2002 to US$ 450 million by the end of 2005. As of May 2006, total deposits were at US$ 506.67 million, with members' deposits at US$ 321.05 million and non-members' deposits at US$ 185.62 million.

Questions

1. Study and compare the Classic and General Microfinance models of Grameen Bank.
2. Examine the reasons that prompted the bank to introduce a new, more flexible credit system.
3. Analyze the advantages and disadvantages of Grameen General Microfinance model.

Source: http://www.icmrindia.org/casestudies/

3.6 Summary

- The Modern banking System started with the opening of Bank of England in 1964 whereas Bank of Hindustan was the first bank to be established in India in 1770.
- The RBI Act 1934 was passed and the Reserve Bank of India became the first Central bank of the country w.e.f. 01.04.1935, it took over the Central Banking activities from the Imperial Bank of India.
- Banks can be classified as (a) Central Bank, (b) Public Sector Banks, (c) Private Sector Banks, and (d) Cooperative Banks.
- The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems.
- RBI performs its functions with the service motive and not for making profits.
- The Reserve Bank acts not only as the banker's bank but also as the lender of the last resort.
- Banks make a profit by borrowing at a lower rate and lending the same funds at a higher rate of interest.
- CRR ensures that a portion of bank deposits is totally risk-free and it enables RBI to control liquidity in the system.
- Lending rates are the ratios fixed by RBI to lend the money to the customers on the basis of those rates.
- Repo rate is the rate at which banks borrow funds from the RBI to meet the gap between the demands they are facing for money.

Notes

- Every commercial bank has to keep a margin whenever it extends loans against the security.
- Regulation of Consumer credit is used by government or central bank to implement certain regulations on goods sold on credit.

3.7 Keywords

ATMs: Automatic Teller Machines

Bank Rate: The interest rate at which a nation's central bank lends money to domestic banks.

Democratization: The action of making something democratic.

Economy: The wealth and resources of a country or region, esp. in terms of the production and consumption of goods and services.

Governance: Governance is the act of governing. It relates to decisions that define expectations, grant power, or verify performance.

Insolvency: When an individual or organization can no longer meet its financial obligations with its lender or lenders as debts become due.

Interim: An interval of time between one event, process, or period and another.

Liquidity: The ability to convert an asset to cash quickly. Also known as "marketability."

Ownership: The relation of an owner to the thing possessed; possession with the right to transfer possession to others.

Resilience: The physical property of a material that can return to its original shape or position after deformation that does not exceed its elastic limit.

Rural Area: An area outside of cities and towns.

3.8 Review Questions

1. Write a brief note on evolution of banks.
2. What are the different types of banks operating in India?
3. Discuss the role of RBI in Indian banking sector.
4. What are the supervisory functions of RBI?
5. Explain how CRR and SLR help in regulating the cash and fund flows in the hands of people, banks and government?
6. What are the qualitative methods of selective credit control? Discuss in detail.
7. Name different quantitative methods of credit control and explain bank rate policy in detail.
8. Discuss the current scenario of banking system in India.
9. What do you understand by promotional functions of RBI?
10. Who acts as the controller of credit and how?
11. Write notes on (a) Repo Rate, and (b) Reverse Repo Rate.
12. What are the various techniques of credit control?

Notes

Answers: Self Assessment

1.	Nationalized	2.	Agency
3.	Regulation	4.	588
5.	Rural, Rural	6.	Majority
7.	nationalised	8.	Competition
9.	Intimacy	10.	Significance
11.	False	12.	True
13.	False	14.	True
15.	Confirmity	16.	Regulation, credit

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Notes

Unit 4: Credit Creation

CONTENTS

Objectives

Introduction

4.1 Meaning of Credit Creation

4.1.1 Basis of Credit Creation

4.1.2 Contraction of Credit

4.2 Process of Credit Creation

4.3 Limitation of Credit Creation

4.4 Summary

4.5 Keywords

4.6 Review Questions

4.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the meaning of credit creation
- Describe the basis of credit creation
- Explain the process of credit creation
- Discuss the limitations of credit creation

Introduction

In the previous unit, we dealt with the Indian Banking System and its classification. The unit also discussed about the role and functions of RBI and various techniques of credit control. This unit will help you to understand the meaning of credit creation. The various section and sub-section of this unit will also summarize the process and limitations of credit creation.

Essentially, commercial banks are considered as dealers in credit. Interest is the pricing factor that directs them in building business decision. These banks were initially started as institutions for meeting the short term credit requirements of trade industry and commerce and even today, it remains their primary function. In view of that requirement, the legal framework never put restrictions on the credit creation power of these banks. However, legislation always required the central bank of each country to oversee and control that power so that it may not be used to the detriment of social well-being.

4.1 Meaning of Credit Creation

Credit creation is one of the essential functions of a commercial bank. The term credit can be defined in both narrow and broad senses. In broad terms, credit is finance that is made available

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by one party – lender, seller, or shareholder/owner – to another party – borrower, buyer, or a business firm. The former could be a pure lender – a financial institution or a private money lender, a seller/supplier of goods on the promise of the buyer to make payment in future, or a shareholder/owner of a firm making funds available to the firm recognized as a separate entity. More commonly, the term credit is practiced in a narrow sense that is only for debt finance. Credit is simply the opposite of debt; both are created instantly by the same contract. It is a special sort of exchange transaction involving future payments, interest added to debt at its time value. This view of credit lies at the heart of modern commercial banking.

The commercial banks create multiple expansions of their bank deposits and due to this, these are called the factories of credit.

Notes The major portion of the deposits of commercial banks is given as advance to the borrowers and the smaller one is kept by themselves.

The customers have full faith on the bank. The banks expand loans by much more than the amount of cash possessed by them. This tendency on the part of the banks to lend more than the amount of cash possessed by them is called creation of credit in economics. Credit creation constitutes the major component of money supply in the economy. Commercial banks differ from other financial institutions in this aspect. Other financial institutions transfer money from the lenders to the borrowers.

While performing the same function, commercial banks create credit or bank money also. The process of credit creation takes place when banks provide loans and advances and accepts deposits. When the customer deposits money with the bank, they are called primary deposits. This money will not be withdrawn by them immediately. Hence, banks keeps a certain amount of deposits as reserves which is known as cash reserve ratio and provide the balance amount as loans and advances. Thus, each and every deposit creates a loan. Commercial banks give loans and advances against some security to the public. But the bank does not give the amount of loan directly. It opens an account in the name of the borrower and deposits the amount in that account. Thus, every loan creates a deposit. The loan amount can be withdrawn by means of cheques. They create deposits while lending money as well. These deposits created by banks with the help of primary deposits are called derivative deposits.

These loans are used by customers to make payments. While paying they issue a cheque against these deposits. The person who receives the cheque, deposit it in another bank. For that bank, this will be the primary deposit. A part of the deposit will be kept as a reserve and the balance will be used for giving loans and advances. This process is repeated by other banks. When all the banks are involved in this process, it is called Multiple Credit Creation.

Reserve Bank of India is the first source of supply of money in the form of currency in circulation. The central bank is the only note issuing authority of the country. The RBI ensures availability of currency to meet the transaction needs of the economy. The total volume of money in the economy should be enough to facilitate the various types of economic activities such as production, distribution and consumption. The commercial banks are the second most significant source of money supply. The money supplied by commercial banks is called as the credit money.

Normally, banks create credit in two ways:

- By over drafting.
- By purchase of securities.

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According to Benhen, "*A bank may receive interest simply by permitting a customer to overdraw their account or by purchasing securities and having for them with its own cheques. Thus, increasing the total bank drafts. One should remember that single bank creates a very little credit. It is a whole banking system which can expand the credit.*"

Secondly when loans are advanced, it is not given in cash. The bank opens a deposit account in the name of the borrower and allows him to withdraw whenever required.

Notes The loans that are advanced by cheques results in the creation of new demand deposits.

Sometimes, a question arises that if the borrower withdraws these deposits for the repayment to other individual, then how will credit be created by the banks. The answer is that other individuals who receive money may also be the clients of the bank. Naturally they will also deposit their cash in the same bank. This process keeps on repeating itself. It can be better explained by the following example:

Example: Suppose a person deposits 1,000 in a bank. According to experience bank can keep 20% cash reserve to meet the demands of the depositors, and can lend the rest safely to the borrowers. If the entire bank maintains a reserve ratio of 20% then banks can succeed in creating a credit a credit of ₹ 5000 against an original deposit of ₹ 1,000 in cash.

Task Visit a commercial bank and enquire a high level bank personnel about the process of credit creation.

4.1.1 Basis of Credit Creation

Bank deposit is the basis for credit money. The bank deposits are of two kinds' viz., (1) Primary deposits, and (2) Derivative deposits.

1. ***Primary Deposits:*** Primary deposits arise or spring up when cash or cheque is deposited by customers. When a person deposits cash or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants through cheque. These deposits are called "primary deposits" or "cash deposits." It is out of these primary deposits that the banks provide loans and advances to its customers. The initiative is taken by the customers themselves. In this case, bank plays a passive role. So, these deposits are also called "passive deposits." These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.

2. ***Derivative Deposits:*** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called "derivative deposits." Since the bank play an active role in the creation of such deposits, they are also known as "active deposits." When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. No cash is paid by the bank to the banker for doing so. Customer is free to withdraw the amount whenever he require by the medium of cheque. Thus, the banker lends money in the form of deposit

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credit. The creation of a derivative deposit results in a net increase in the total supply of money in the economy; Hartly Withers says "every loan creates a deposit." It may also be said "loans make deposits" or "loans create deposits." It is rightly said that "deposits are the children of loans, and credit is the creation of bank clerk's pen."

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank purchase government securities or discounts a bill. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus, assets acquired by a bank create equivalent bank deposits. It is perfectly correct to state that "bank loans create deposits." The derivative deposits are regarded as bank money or credit. Thus, the power of commercial banks to expand deposits through loans, advances and investments is known as "credit creation." Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as "the expansion of bank deposits through the process of more loans and advances and investments."

Caselet

Credit Creation by Banks

Suppose there are a number of Commercial Banks in the Banking System – Bank 1, Bank 2, Bank 3, & So on.

To begin with let us suppose that an individual "A" makes a deposit of ₹ 100 in bank 1. Bank "1" is required to maintain a Cash Reserve Requirement of 5% (Prevailing Rate) which is decided by the RBI's Monetary Policy from the deposits made by 'A'. Bank "1" is required to maintain a cash reserve of ₹ 5 (5% of 100). The bank has now lendable funds of ₹ 95(100 – 5). Let the Bank "1" lend ₹ 95 to a borrower; say B, the method of lending is the same that is bank 1 opens an account in the name of the borrower cheque for the loan amount. At the end of the process of deposits & lending, the balance sheet of bank reads as given below:

Balance Sheet of Bank

Liabilities	Amount	Assets	Amount
A's deposits	100	Cash Reserve	5
		Loan to "B"	95
Total	**100**	**Total**	**100**

Now bank 2 carries out its banking transaction. It keeps a cash reserve to the extend of 5%, that is ₹ 4.75 (5% of 95) and lend ₹ 90.5 to a borrower D. at the end of the process the balance sheet of Bank 2 will be look like:

Balance Sheet of Bank

Liabilities	Amount	Assets	Amount
B's deposits	95	Cash Reserve	4.75
		Loan to "C"	90.5
Total	**95**	**Total**	**95**

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The amount advanced to D will return ultimately to the banking system, as described in case of B and the process of deposits and credit creation will continue until the reserve with the banks is reduced to zero. The final picture that would emerge at the end of the process of deposit & credit creation by the banking system is presented in the consolidated balance sheet of all banks are as under:

Bank	Liabilities Deposits	Assets Credits	Reserve	Total Assets
Bank 1	100	95	5	100
Bank 2	95	90.5	4.75	95
Bank 3	90.5	85.98	4.52	90.5
-	-	-	-	-
-	-	-	-	-
Bank n	00	00	00	00
Total	**2,000**	**1,900**	**100**	**2,000**

It can be seen from the combined balance sheet that a primary deposits of ₹ 100 in a bank 1 leads to the creation of the total deposit of ₹ 2,000. The combined balance sheet also shows that the banks have created a total credit of ₹ 2,000. And maintained a total cash reserve of ₹ 100 which equals the primary deposits. The total deposit created by the commercial banks constitutes the money supply by the banks.

Source: http://www.indianmba.com/Occasional_Papers/OP217/op217.html

4.1.2 Contraction of Credit

The money supply is adversely affected by the contraction of credit. The contraction of bank credit may take place due to many reasons.

Example: The bank may recall loans or due to political uncertainty or due to fall in price borrower may stop the borrowing.

According to Pritchard, "*Contraction by any single bank in this system will place pressure on other banks and if their excess reserve position is inadequate and the banks are unable to meet their excess reserves through the agency of the central bank then a multiple process of credit contraction will start.*"

Self Assessment

Fill in the blanks:

1. Credit creation constitutes the major component of money supply in the …….
2. When the customer deposits money with the bank, they are called ……. deposits.
3. …… bank is the first source of money supply in the form of currency in circulation.
4. The RBI ensures availability of currency to meet the …… needs of the economy.
5. The …… banks are the second most important sources of money supply.

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6. When a person deposits money or cheque, the bank will …….. his account.

7. Deposits which arise on account of granting loan or purchase of assets by a bank are called "……..."

4.2 Process of Credit Creation

The process of 'Credit Creation' begins when money is lent by banks out of primary deposits. In fact banks cannot lend the entire primary deposits as they are required to maintain a certain proportion of primary deposits in the form of reserves with the RBI under RBI & Banking Regulation Act. After maintaining the required reserves, the bank can lend the remaining portion of primary deposits. Here banks lend the money and there the process of credit creation starts.

A significant aspect of the credit creating function of the commercial banks is the process of multiple-expansion of credit.

Did u know? The banking system as a whole can create credit which is several times more than the original increase in the deposits of a bank. This process is called the multiple-expansion or multiple-creation of credit.

Similarly, if there is withdrawal from any one bank, it leads to the process of multiple-contraction of credit. The process of multiple credit-expansions can be illustrated by assuming:

(a) The existence of a number of banks, A, B, C etc., each with different sets of depositors,

(b) Every bank has to keep 10% of cash reserves, according to law, and

(c) A new deposit of ₹ 1,000 has been made with bank A to start with.

Suppose, a person deposits ₹ 1,000 cash in Bank A. As a result, the deposits of bank A increase by ₹ 1,000 and cash also increases by ₹ 1,000. The balance sheet of the bank is as follows:

Balance Sheet of Bank A

Liabilities	₹	Assets	₹
New deposit	1,000	New Cash	1,000
Total	1,000		1,000

Under the double entry system, the amount of ₹ 1,000 is shown on both sides. The deposit of ₹ 1,000 is a liability for the bank and it is also an asset to the bank. Bank A has to keep only 10% cash reserve, i.e., ₹ 100 against its new deposit and it has a surplus of ₹ 900 which it can profitably utilize in the assets like loans. Suppose bank A gives a loan to X, who uses the amount to pay off his creditors. After the loan has been made and the amount so withdrawn by X to pay off his creditors, the balance sheet of bank A will be as follows:

Balance Sheet of Bank A

Liabilities	₹	Assets	₹
Deposit	1,000	New Cash Loan to X	100 900
Total	1,000		1,000

Suppose X purchase goods of the value of ₹ 900 from Y and pay cash. Y deposits the amount with Bank B. The deposits of Bank B now increase by ₹ 900 and its cash also increases by ₹ 900. After

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keeping a cash reserve of ₹ 90, Bank B is free to lend the balance of ₹ 810 to anyone. Suppose bank B lends ₹ 810 to Z, who uses the amount to pay off his creditors. The balance sheet of bank B will be as follows:

Balance Sheet of Bank B

Liabilities	₹	Assets	₹
Deposit	900	Cash	90
		Loan to Z	810
Total	900		900

Suppose Z purchases goods of the value of ₹ 810 from S and pays the amount. S deposits the amount of ₹ 810 in bank C. Bank C now keeps 10% as reserve (₹ 81) and lends ₹ 729 to a merchant. The balance sheet of bank C will be as follows:

Balance Sheet of Bank C

Liabilities	₹	Assets	₹
Deposit	810	Cash	81
		Loan	729
Total	810		810

Thus, looking at the banking system as a whole, the position will be as follow:

Name of the Bank	Deposits ₹	Cash reserve ₹	Loan ₹
Bank A	1,000	100	900
Bank B	900	90	810
Bank C	810	81	729
Total	2710	271	2,439

It is clear from the above example that out of the initial primary deposit, bank advanced ₹ 900 as a loan. It created the primary deposit of bank B, which in turn advanced ₹ 810 as loan. This sum again creates the primary deposit of bank C, which in turn advanced ₹ 729 as loan. Thus, the initial primary deposit of ₹ 1,000 resulted in bank credit of ₹ 2439 in three banks. There will be many banks in the country and the above process of credit expansion will come to an end when no bank has an excess reserve to lend. In the above example, there will be 10 fold increase in credit because the cash ratio is 10%. The total volume of credit created in the banking system depends on the cash ratio. If the cash ratio is 10% there will be 10 fold increase. If it is 20%, there will be 5 fold increase. When the banking system receives an additional primary deposit, there will be multiple expansion of credit. When the banking system loses cash, there will be multiple contraction of credit. The extent to which the banks can create credit together could be found out with the help of the credit multiplier formula. The formula is:

$$K = \frac{1}{r}$$

Where K is the credit multiplier, and r, the required reserves. If the reserve ratio is 10% the size of credit multiplier will be:

$$K = \frac{1}{r} - \frac{1}{0.1} = 10$$

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It means that the banking system can create credit together which is ten times more than the original increase in the deposits. It should be noted here that the size of credit multiplier is inversely related to the percentage of cash reserves the banks have to maintain.

Caution If the reserve ratio increases, the size of credit multiplier is reduced and if the reserve ratio is reduced, the size of credit multiplier will increase.

Self Assessment

Fill in the blanks:

8. Banks cannot lend the entire primary deposits as they are required to maintain a certain proportion of primary deposits in the form of …….. with the RBI under RBI & Banking Regulation Act.
9. The banking system as a whole can create …… which is several times more than the original increase in the deposits of a bank.

4.3 Limitation of Credit Creation

Though commercial banks have the power to create credit, they possess limited powers. Certain factors affect the process of credit creation. They are termed as limitations to credit creation by commercial banks.

The limitations of credit creation by commercial banks are as follows:

- ***Amount of Deposit:*** The most significant factor which determines credit creation is the amount of deposits made by the depositors. Higher is the amount of deposits; greater is the supply of credit and vice versa.
- ***Cash Reserve Ratio (CRR):*** There exists an indirect relationship between Credit Creation and Cash Reserve Ratio. Higher is the Cash Reserve Ratio more will be the reserves to be maintained and less credit will be created by banks. The CRR is fixed by the RBI in India. It ranges from 3% to 15%.
- ***Banking Habits of People:*** If the banking habits of the people are well-developed, then all of their transactions would be through banks, and this will lead to expansion of credit and vice-versa.
- ***Supply of Securities:*** Loans are sanctioned on the basis of the securities provided to the banks. If securities are available then the credit creation will be more and vice-versa.
- ***Willingness of people to borrow:*** Commercial banks may have enough money to lend. Customers should be willing to borrow from the banks to facilitate credit creation. If they are willing to borrow, then the credit created by banks will be less.
- ***Monetary Policy of Central Bank:*** While credit is created by commercial banks, it is controlled by the Central Bank. Credit control is one important function of the central bank. Central Bank uses various methods of Credit Control from time to time and thus influences the banks to expand or contract credit.
- ***External Drain:*** External Drain refers to withdrawal of cash from the banking system by the public. It lowers the reserves of the banks and limits the credit creation.

Notes

- ***Uniform Policy:*** If all the commercial banks follow a uniform policy related to CRR, then credit creation would be smooth. If some banks follow liberal and others follow a conservative one, then credit creation would be affected.

Thus, various limitations hinder the path of ability of the banks to create credit. Still, one should not underestimate the significance of credit creation function of the banks. This function has long-run implications on the functioning of the economy, particularly on the activities of business. Bank credit acts as the oil which lubricates the wheels of the business machine.

Self Assessment

Fill in the blanks:

10. External Drain refers to ……. of cash from the banking system by the public.
11. Bank credit is the oil which ……. the wheels of the business machine.
12. Loans are sanctioned on the basis of the …….. provided to the banks.
13. There is a/an …… relationship between the amount of deposits and supply of credit.
14. Credit is created by …… banks, it is controlled by the …… Bank.
15. External Drain …… the reserves of the banks.

Case Study

Bhatt Enterprises – Cash Forecasting and Investing

Sushma is the Treasurer of Bhatt Enterprises, a poorly organized collection of financial services companies. The composition of Bhatt's activities can best be seen in a statement of forecasted cash flow by each major business line, namely:

	Annual Cash Flow
Insurance policies	$ 85,000,000
Insurance underwriting	55,000,000
Assets based lending	200,000,000
Consumer paper	155,000,000
Auto dealer paper	80,000,000
	$ 575,000,000

Sushma has inherited a concentration banking system, as shown in Figure 1. After examining its features, he felt satisfied that it meets the needs of Bhatt Enterprises. The hometown bank in San Francisco. California is not a member of any clearinghouse; all cheques are processed through a correspondent relationship with security. The lockboxes in Phoenix and Seattle are efficiently managed by security and thus, average only one day float. This is the same as for funds deposited directly as security. Excess funds are wired daily to New Jersey for same day investment.

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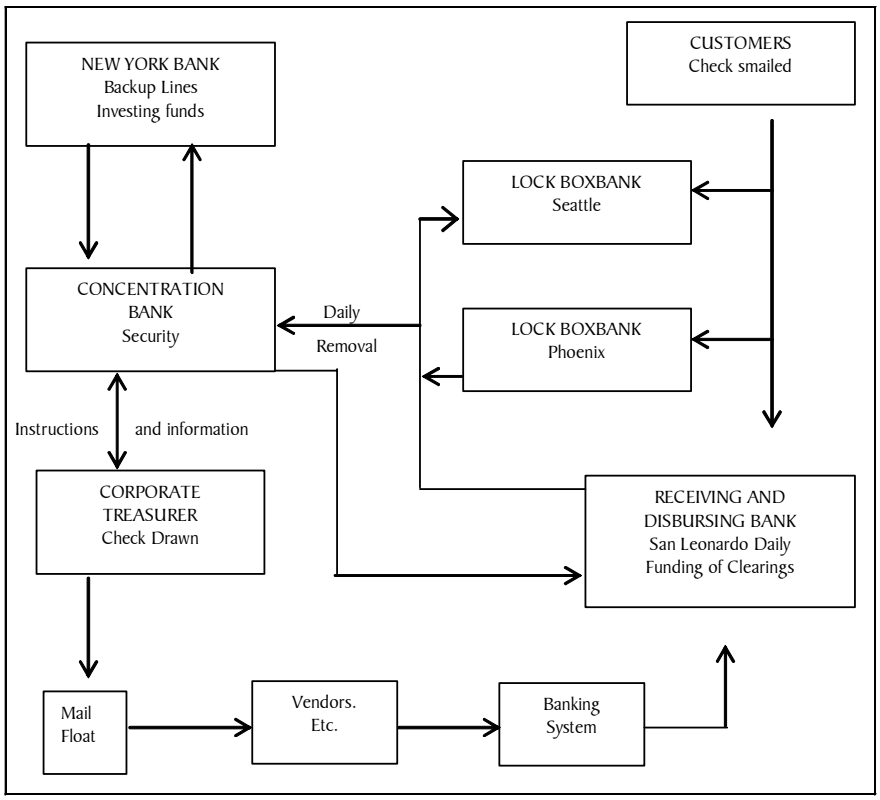

Figure 1: Bhatt Enterprises Concentration Banking System

On September 8, Sushma is preparing his monthly report on funds invested during August. Table 1 shows the deposits each day during the month. It also shows the book disbursements: that is, checks written but not clearing each day. This information comes directly from the ledger accounts of Bhatt Enterprises.

Table 1: Daily Deposits and Cheques Drawn, Bhatt Enterprises

For the Month of August Starting Balance	Daily Deposit	Cheques Drawn	Books Balance
			3,20,000
1	2,150,000	1,740,000	7,30,000
2	1,340,000	1,765,000	3,05,000
3	0	0	3,05,000
4	0	0	3,05,000
5	2,330,000	1,292,000	1,343,000
6	1,475,000	1,628,000	1,191,000
7	2,567,000	1,555,000	1,202,000
8	2,300,000	1,432,000	3,070,000
9	1,278,000	1,606,000	2,742,000
10	0	0	2,742,000
11	0	0	2,742,000
12	2,879,000	1,666,000	3,955,000

Contd...

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13	2,075,000	2,925,000	3,105,000
14	1,444,000	2,450,000	2,099,000
15	2,316,000	2,650,000	1,765,000
16	978,000	1,605,000	1,138,000
17	0	0	1,138,000
18	0	0	1,138,000
19	3,015,000	1,777,000	2,376,000
20	1,866, 000	2,355,000	1,887,000
21	1,924,000	2,202,000	1,791,000
22	2,416,000	2,330,000	1,877, 000
23	1,555, 000	1,270, 000	1,162, 000
24	0	0	1,162, 000
25	0	0	1,162, 000
26	2,650, 000	1,348, 000	2,464, 000
27	1,145, 000	2,603, 000	1,006, 000
28	3,065, 000	2,588, 000	1,483, 000
29	2,205, 000	2,346, 000	1,342, 000
30	2,488, 000	1,758, 000	2,072, 000
31	0	0	2,072, 000

Table 2: New Goods Funds Credited Daily, Bhatt Enterprises

For the Month of August Starting Balance	New Goods Funds	Cheques Cleared	Books Balance
			700.000
1	1,832,000	1,460,600	1,069,400
2	2,055,000	1,832,250	1,292,150
3	0	0	1,292,150
4	0	0	1,292,150
5	8,69,480	1,352,650	808,980
6	2,123,400	2,303,750	628,630
7	1,467,300	2,292,950	(197,020)
8	2,454,400	1,524,900	723,480
9	2,300,120	1,142,700	1,880,900
10	0	0	1,880,900
11	0	0	1,880,900
12	3,40,600	1,645,160	576,350
13	2,790,680	1,511,950	1,855,080
14	2,040,240	1,492,900	2,402,420
15	1,481,680	1,043,900	2,840,200
16	2,070,120	3,072,850	1,837,470
17	0	0	1,837,470
18	0	0	1,837,470

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19	1,174,834	2,758,750	253,554
20	3,366,940	2,555,000	1,065,494
21	1,860,300	2,349,250	576,544
22	1,903,860	1,043,250	1,437,154
23	2,400,000	3,100,740	736,414
24	0	0	736,414
25	0	0	736,414
26	1,699,680	2,237,750	198,344
27	2,986,200	2,128,500	1,056,044
28	1,195,500	2,309,000	(57,456)
29	2,882,200	1,475,500	1,349,244
30	2,246,300	506,800	3,088,744
31	0	0	3,088,744
Total	44,917,294	41,385,850	

Separately, Table 2 shows the new good funds credits to Bhatt account each day in August. It also shows the cheques that cleared, as reported by the bank.

Questions

1. Draw the monthly report giving the real picture about:
   (a) Total Cheques Written
   (b) Average Cash Balance
2. For how many days, the firms have negative cash balance and also mention the day of week, which has highest level of deposit and highest level of cheques written.

Source: Sudhindra Bhatt, "*Financial Management – Principles and Practice*", Excel Books

4.4 Summary

- Credit creation is one of the essential functions of a commercial bank. Credit is finance that is made available by one party – lender, seller, or shareholder / owner – to another party – borrower, buyer, or a business firm.
- Credit is simply the opposite of debt; both are created instantly by the same contract. It is a special sort of exchange transaction involving future payments, interest added to debt at its time value.
- The commercial banks create multiple expansions of their bank deposits and due to this, these are called the factories of credit.
- Credit creation constitutes the major component of money supply in the economy. Commercial banks differ from other financial institutions in this aspect.
- Commercial banks give loans and advances against some security to the public. But the bank does not give the amount of loan directly. It opens an account in the name of the borrower and deposits the amount in that account.
- Reserve Bank of India is the first source of supply of money in the form of currency in circulation. The central bank is the only note issuing authority of the country. The RBI ensures availability of currency to meet the transaction needs of the economy.

Notes

- Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank purchase government securities or discounts a bill.
- Contraction by any single bank in this system will place pressure on other banks and if their excess reserve position is inadequate and the banks are unable to meet their excess reserves through the agency of the central bank then a multiple process of credit contraction will start.
- The most significant factor which determines credit creation is the amount of deposits made by the depositors. Higher is the amount of deposits; greater is the supply of credit and vice versa.
- If the banking habits of the people are well-developed, then all of their transactions would be through banks, and this will lead to expansion of credit and vice-versa.
- External Drain refers to withdrawal of cash from the banking system by the public. It lowers the reserves of the banks and limits the credit creation.
- If all the commercial banks follow a uniform policy related to CRR, then credit creation would be smooth. If some banks follow liberal and others follow a conservative one, then credit creation would be affected.

4.5 Keywords

Active Deposits: Its id the other name for derivative deposits.

Borrow: Take and use money from a person or bank under an agreement to pay it back later.

Contraction: The act of decreasing (something) in size or volume or quantity or scope.

Credit: The ability to obtain goods or services before payment, based on the trust that payment will be made in the future.

Cash Reserve Ratio (CRR): CRR is the amount of funds that all Scheduled Commercial Banks excluding Regional Rural Banks are required to maintain without any floor or ceiling rate with RBI with reference to their total net Demand and Time Liabilities to ensure the liquidity and solvency of Banks.

Deposit: A sum of money placed or kept in a bank account, usually to gain interest.

External Drain: It refers to withdrawal of cash from the banking system by the public. It lowers the reserves of the banks and limits the credit creation.

Passive Deposits: It is the other name for primary deposits.

Statutory Liquidity Ratio (SLR): The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio.

4.6 Review Questions

1. Define the term 'Credit'.
2. What do you mean by 'credit creation'?
3. Describe the measures by which banks create credit.
4. What is the basis of credit creation?
5. What do you understand by contraction of credit?
6. Write short note on multiple credit creation.

Notes

7. Explain the process of credit creation.
8. What are the limitations of credit creation?
9. What is credit multiplier formula?
10. What is the important aspect of the credit creating function of the commercial banks?

Answers: Self Assessment

1.	Economy	2.	Primary
3.	Central	4.	Transaction
5.	Commercial	6.	Credit
7.	Derivative Deposits	8.	Reserves
9.	Credit	10.	Withdrawal
11.	Lubricates	12.	Securities
13.	direct	14.	Commercial; Central
15.	lowers		

4.7 Further Readings

Books

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Shekhar, K C (2009), *"Banking Theory and Practice"*, Vikas Publishing House Pvt. Ltd.

Online links

http://www.preservearticles.com/201012281863/credit-creation.html

http://www.indiastudychannel.com/resources/108889-Credit-Creation-Limitations-Bank.aspx

http://www.indiastudychannel.com/resources/108889-Credit-Creation-Limitations-Bank.aspx

http://www.preservearticles.com/2012033129435/10-main-limitations-on-credit-creation.html

Notes

Unit 5: Banker Customer Relationship

CONTENTS

Objectives

Introduction

5.1 Various Types of Relationship

5.2 KYC Norms

5.2.1 Objectives

5.3 Special Types of Accounts

5.3.1 Current Account

5.3.2 Savings Account

5.3.3 Recurring Account

5.3.4 Fixed Deposits

5.4 Mandate and Power of Attorney

5.4.1 Banke Lien

5.4.2 Right of Set off

5.4.3 Garnishee Order and Attachment Order

5.5 Summary

5.6 Keywords

5.7 Review Questions

5.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the various types of relationship
- Elaborate KYC Norms
- Explain the special types of accounts
- Elaborate mandate & power of attorney
- Describe Banker's Lien, Right of set off, Garnishee and Attachment Order

Introduction

In the previous unit, we dealt with the process of credit creation. The unit also discussed about the various limitations of credit creation. This unit will help you to discuss various types of relationship and special types of accounts. The various section and sub section of this unit will also summarize the concepts of KYC norms, Garnishee Order and Attachment Order. The Banking Regulation Act, 1949 defines 'Banking' as accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawal by

Notes

cheque, draft order or otherwise (Sec. 5b) and says that any company which transacts the business of banking is a 'Banking Company '(Sec. 5c).

A customer is one who has a (Saving/Current/Fixed) deposit account irrespective of its debit or credit balance with the bank. Even an agreement to open an account makes one a customer. But one, who has any other transactions/business only, but no account with the bank, cannot be called its customer.

5.1 Various Types of Relationship

The primary relationship, which flows from the essential function of a bank, is of debtor creditor or vice vea (i.e. when the account shows debit balance) with its custome. But depending on other various functions being performed by banks, several other relationships may also exist.

1. ***Debtor-Creditor:*** When a bank accepts deposits, it becomes debtor and the depositor a creditor irrespective of the fact the bank pays interest or not. But the relationship is of a special nature, as established by several judgments. Some of the special features of this relationship are discussed below:

   (a) The customer cannot claim return of the same notes or coins from bank, which can repay a sum of equivalent amount.

   (b) The depositor being a creditor, is an unsecured creditor notwithstanding the fact that the deposits are insured up to ₹ 1 lakh per depositor by DI&CGC (BDIC)), the premium being born by bank @ 5 paisa per ₹ 100/- per year.

   Caution For repayment, the creditor must raise demand. Limitation for suit for recovery of deposit amount against bank is 3 yea from the date of demand.

   (c) Demand must be made by the customer in prescribed manner only at the branch at which the account is maintained and also within normal business hou on working day only. It is pertinent to add here that payment made outside business hou is not a payment in due coue, thus depriving the bank of the protection available under Sec. 85 and 85A of NI Act.

   When the customer overdraws his account, the customer becomes debtor and the banker becomes creditor.

2. ***Trustee-Beneficiary:*** Banks may also act as trustee. The position of a bank will be that a trustee when:

   (a) A Peon having no account with a bank, deposit money with instruction to retain it till further instructions.

   (b) The customer instruct a bank to debit his account or deposits an amount for utilising it for a specific purpose or for remitting to other branch/bank. (But in absence of specific instruction, this relationship will not be established).

   (c) Manages properties of its customer.

3. ***Agent-Principal:*** When the banker accepts, bills etc. for collection on behalf of his customer, he acts as an agent and the constituents. In such cases the bank is duty bound as per sec 151 of Indian Contract Act, 1872 to act with reasonable diligence and skill as per instruction of the principal; (in absence of instruction as per customs). Falling which, to make good the loss, if any, as per Sections 211 and 212 of Indian Contract Act.

Notes

4. ***Bailee-Bailor:*** When a bank accepts article for safe custody, its legal position is that of bailee, who is duty-bound to take us much care of the goods bailed to him as man of ordinary prudence would, under similar circumstances, take of his own similar goods. Sec. 152 of the same act says that the bailee, in absence of any contract to the contrary is not responsible for any loss if the bailee has taken care as required in terms of sec. 151 of the Act (as narrated in the immediately preceding sentences). Bailee has right of particular lien in terms of sec. 170 of Indian Contract Act, which says that bank has right goods bailed until he receives remuneration for his services rendered in respect of them, unless there is a contract to the contrary.

Example: When someone drops a car off with a mechanic for a tune up. In this case, the driver is the bailor, as the car legally belongs to the driver while the mechanic has the car in physical custody for the agreed upon service.

5. ***Lessor-Lessee:*** On hiring out of locker, bank becomes lessor and the hirer a lessee and the relationship is that of landlord and tenant. The lessor is not responsible for any loss or damage suitable clause to the effect is also incorporated in the Lease Deed and hire are advised, in their own interest, to insure their valuables deposited in locker.

5.2 KYC Norms

"Know your Customer" is a term used for customer identification which involves making reasonable efforts to determine true identity and beneficial ownehip of accounts, source of funds, the nature of customer's business, fairness of operations in the account in relation to the customer's business, etc. so as to help the banks to manage their risks cautiously.

5.2.1 Objectives

The objectives of the policy are to prevent criminal elements from using the bank for money laundering activities by enabling the bank to know/undetand the custome and their financial dealings better, which, in turn, would help the bank to manage risks prudently and to lay in place appropriate controls for accounting and spotting of wary activities in accordance with the established operations so as to abide by with applicable laws and regulatory guidelines.

KYC has two components - Identity and Address. The banks need to periodically change their records since although the identity remains the same, but the address may change.

The framework of KYC norms mainly incorporates the following four key elements:

- Customer Acceptance Policy;
- Customer Identification Procedures;
- Monitoring of Transactions; and
- Risk Management.

1. ***Customer Acceptance Policy:*** The Bank will:

   i. classify custome into various risk categories and based on risk perception decide on acceptance criteria for each category of custome;

   ii. accept custome after verifying their identity as laid down in Customer Identification Procedures;

   iii. not open accounts in the name of anonymous/fictitious/benami peon(s); and

Notes

iv. while carrying out due diligence, ensure that the procedure adopted will not result in denial of banking services to the general public especially those who are financially or socially disadvantaged.

2. ***Customer Identification Procedure:*** The fit requirement of customer identification procedure is to be satisfied that

   i. a prospective customer is who he/she claims to be,

   ii. the second requirement of customer identification procedures is to ensure that sufficient information is obtained on the nature of the business that the customer expects to undertake, and any expected, or predictable, pattern of transactions and The information collected will be used for profiling the customer,

   iii. the identity is to be verified for:

      (a) the named account holder;

      (b) the beneficial owne;

      (c) the signatories to an account; and

      (d) the intermediary parties.

   iv. the Customer Identification Procedures are to be carried out at the stages:

      (a) While establishing a banking relationship

      (b) When the bank feels it is necessary to obtain additional information from the existing custome based on the conduct or behaviour of the account.

      Documents to verify the name/identity of the customer:

      (a) passport,

      (b) PAN card,

      (c) voter identity card,

      (d) driving license with photograph,

      (e) identity card,

      (f) letter from a recognized public authority verifying the identity and residence of the customer to the satisfaction of the branch official authorized to open the account,

      (g) confirmation/ letter from employer/ other bank (subject to satisfaction of the branch official authorized to open the account).

      Documents to verify the address are:

      (a) Telephone Bill,

      (b) Bank account Statement,

      (c) Electricity bill,

      (d) Ration Card,

      (e) letter from employer to the satisfaction of the bank.

3. ***Monitoring of Transactions:*** Monitoring of transactions will be conducted taking into consideration the risk profile of the account. Special attention will be paid to all complex,

unusually large transactions and all unusual patterns, which have no apparent logical or visible lawful purpose. Transactions that involve large amounts of cash inconsistent with the normal and expected activity of the customer will be subjected to detailed scrutiny.

After due diligence at the appropriate level in the Bank, transactions of suspicious nature and/or any other type of transaction notified under PML Act, 2002 will be reported to the appropriate authority and a record of such transactions will be preserved and maintained for a period as prescribed in the Act.

Branches would be maintaining a close watch on cash transactions (whether deposits or withdrawals) of ₹ 10 lakh and above in all deposit and loan accounts and recording the same separately in the prescribed register. Besides, the branches would also be reporting all cash transactions of ₹ 10 lakh and above with full details to their controlling offices through a periodical statement, on fortnightly basis. The controlling offices would scrutinize the same and, if required, make enquiries from the branches in case the cash deposit/withdrawal is not in consonance with the known profile of the customer and follow up with the branches till logical end. In case, the controlling offices find that the report is in order, no further action would be taken and the designated officer in RO/ZO would close the report.

4. ***Risk Management:*** The Board of Directo of the bank should ensure that an effective and efficient KYC program is put in place by establishing appropriate procedures and ensuring their proper execution. It should cover proper management supervision, segregation of responsibilities, systems and controls, training and other related matte. Responsibility should be explicitly apportioned within the bank for ensuring that the bank's policies and procedures are carried out effectively.

Banks must have an ongoing employee training programme so that the membe of the staff are adequately trained in KYC procedures. Training requirements should have different focuses for frontline staff, compliance staff and staff dealing with new custome. It is crucial that all those concerned fully undetand the principle behind the KYC policies and enforce them systematically.

Notes In December 2012, RBI eased the mandatory KYC norms for banks so that opening a bank account will be simple and hassle free.

Self Assessment

Fill in the blanks:

1. The two components of KYC norms are ..... & .....
2. The objective of KYC policies is to .....
3. Transactions involving ..... will be subjected to detailed scrutiny.

5.3 Special Types of Accounts

A financial account between a bank and a customer is known as a bank account. Deposit accounts are those accounts which are opened with the purpose of holding credit balances whereas loan accounts are opened with the purpose of holding debit balances. Accounts are categorized by the function rather than nature of the balance they hold, e.g. savings account.

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5.3.1 Current Account

An account which can be operated any number of times on a working day without any restriction on the number and amount of withdrawals is known as a current account. As the banker is under a responsibility to repay these deposits on demand, they are called deemed deposits.

Current accounts suit the requirements of joint stock companies, public authorities, corporations, etc. whose banking transactions happen to be numerous per day. Cheque facility is available for the investo.

A current account carries certain privileges which are not available to other account holde

1. Third party cheques and cheques with endoements may be deposited in the current account for collection and credit.
2. Overdraft facilities are given in case of current accounts only.
3. The loans allowed by banks to their custome are not given in the form of cash but via the current accounts. Thus current accounts earn interest on all types of advances allowed by the banker.

5.3.2 Savings Account

The main purpose of savings accounts is encouraging savings of households. The main features of savings account are:

1. ***Restriction on withdrawals:*** In the interest of the objective of savings bank accounts, the banks levy certain limitations on the right of depositor to withdraw money within a given period. The number of withdrawals over a period of 6 months is limited to 50. Minimum amount to withdraw by a withdrawal form is ₹ 1 and that from a cheque is ₹ 5.
2. ***Restriction on deposits:*** The banks do not accept cheques or other official documents payable to a third party for the purpose of deposit in the savings account.
3. ***Minimum balance:*** There is a minimum balance that needs to be maintained in the SB accounts as prescribed by the banks and specific charges are levied if the minimum balance is not maintained.
4. ***Payment of interest:*** The rate of interest payable by the banks on deposits maintained in savings accounts is prescribed by the RBI. Interest is computed at quarterly or longer rests of period.
5. ***Cheques:*** Cheque facility is provided to the deposito only when they keep a minimum balance with the bank according to its rules. Only cheques payable to the custome having SB accounts are collected.
6. ***Prohibition on savings account:*** The RBI has forbade the banks to open a savings account in the name of
   (a) Trading or business concern.
   (b) A company or an association.
   (c) Government departments.
   (d) Bodies depending upon budgetary allocations for performance of their functions.
   (e) Municipal corporations.

Notes

(f) Panchayat samitis.

(g) State housing boards.

The difference between savings account and current account can be summed up as follows:

Feature/Service	Savings Account	Current Account
Business Banking	Not Applicable	Yes
Minimum Balance	Required	Higher
ATM Cards	Available	Available
Interest Rate	Applicable	Mostly No
Bank Overdraft	No	Yes
International Transactions	Depends	Yes
Deposit Interval	Not Applicable	As per bank
Daily Withdrawal Limits	Applicable	Not Applicable, Mostly

Savings account and Current account come under the demand deposits account.

5.3.3 Recurring Account

In order to inculcate the habit of savings on a regular or recurring basis, the banks have started various daily, weekly, or monthly deposit schemes in recent yea. In these accounts, the money is generally deposited in monthly installments for a fixed period and is repaid to the deposito along with interest on maturity. These are referred to as recurring deposits. The period of recurring deposit varies from bank to bank. Generally banks open such accounts ranging from one to ten yea.

1. ***Opening and functioning of account:*** The RD account can be opened by any peon, by a guardian in the name of a minor and even by a minor, more than one peon jointly or individually.

   While opening the account, a pass book is provided to the depositor which is to be presented to the bank at the time of deposits and repayment of amount. Installments for each month should be paid before the last working day of that month.

2. ***Rate of interest:*** According to the directive of the RBI, the interest provided by banks on RD must be in accordance with the rates prescribed for various term deposits. The rate of interest is therefore almost equal to that of fixed deposits.

5.3.4 Fixed Deposits

Fixed deposits refer to the deposits repayable after the expiry of a certain period, which generally varies from 3 months to 5 yea. The fixing of the period enables the banker to invest money without having to keep a reserve and hence is very popular with the banke.

1. ***Rate of interest:*** Higher rates of interest are offered on fixed deposits as the depositor parts with liquidity for a certain period. The longer the period, the higher will be the rate of interest.

2. ***FD for senior citizens:*** Special FD schemes have been formulated by RBI for senior citizens in which they are offered higher and fixed rates of interest.

Notes

3. ***FD in joint names:*** FDs can also be opened in joint names of two or more peons, which are payable to either or survivor in accordance with the terms of the acknowledgement. The problems faced by the banker before date of maturity are

   (a) Request for untimely refund by one of the depositor

   (b) Loan against FDR by one of the depositor

   (c) Request for duplicate receipt by one of the depositor

   In all these cases the banker should obtain consent of other depositor/s.

4. ***Payment before due date:*** Even though a FD is payable after expiry of defined period, banks allow encashment even before maturity. In such a case, certain interest will be charged for the same. According to the RBI directive, banks should not charge the penalty in case of premature withdrawal for immediate reinvestment in another FD for a longer term than the remaining period of the original contract.

5. ***Overdue deposits:*** If the receipt is not encashed on the date of maturity, the interest ceases to run from that date. The banks allow interest as per RBI directives, if it is renewed.

Recurring account and fixed deposits come under the time deposit accounts.

Task Visit the branch in which you have an account. Ask about the different types of accounts offered by them to the custome.

Caselet

Fixed Deposits Benefit More from the Power of Compounding

Interest rates may moderate soon. So, it's a good idea to lock into the current high rates being offered by bank deposits. But which deposit scheme should you go for — fixed or recurring?

When interest rates on both are the same, fixed deposits score over recurring deposits. And when a fixed deposit offe higher rates, it wins hands down — thanks to both better returns and better compounding effect. Here's why.

Fit-mover advantage: Say, a bank offe 9 per cent annually on both their fixed deposit and recurring deposit of one-year tenure. The interest income is compounded on a quarterly basis.

So, if you invest ₹ 12,000 in the fixed deposit, you get ₹ 13,117 at maturity at the end of one year. On the other hand, a deposit of ₹ 1,000 each month for 12 months (totalling ₹ 12,000) in the recurring deposit will cumulate to ₹ 12,597 at maturity, ₹ 520 less.

What explains this difference? In the fixed deposit, the entire ₹ 12,000 earns interest from the start, while in the recurring deposit each ₹ 1,000 earns interest only after the instalment is deposited.

Now, say, after depositing the recurring installments, you put the remaining amount (₹ 11,000 after the fit month, ₹ 10,000 after the second, and so on) in a savings bank account which earns interest at 7 per cent (the highest savings bank rate today). Even in this case, the total amount at the end of one year comes to ₹ 12,999 — the sum of the recurring

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deposit balance (₹ 12,597) and the savings account interest (₹ 402). That is still lower than the ₹ 13,117 cumulative balance in the fixed deposit.

The benefit of early start and better interest rate works in favour of the fixed deposit. The longer the tenure of the deposit, the greater is the benefit. Fixed deposits benefit more from the power of compounding.

Tax advantage: Long-term fixed deposits (five yea or more) with a scheduled bank are eligible for tax deduction up to ₹ 1 lakh. This improves the effective return on such deposits. No such tax break is available on recurring deposits. There is no tax deducted at source (TDS) on the interest earned on recurring deposits. In a fixed deposit, if the interest income exceeds ₹ 10,000 in a year, the bank will deduct tax at source and pay you only the balance. But the no-TDS rule does not mean that the interest income on recurring deposits is exempt from tax. Income on both fixed deposits and recurring deposits is taxable, and certainly you have to pay taxes on both (less, of coue, the amount already deducted by the bank).

When to go for Recurring deposits: If you do not have sufficient funds at the beginning and can invest only in installments, then go for a recurring deposit. Regular savings over a long period at a healthy fixed rate of interest can translate into a significant sum.

But note that you need to be disciplined when investing in a recurring deposit. If you do not deposit an instalment, the bank may charge you a penalty. State Bank of India, for instance, charges ₹ 1.50 for every ₹ 100 a month for non-deposit of monthly installments on recurring deposits with tenure of five yea or less. Further, if you do not make deposits for an extended period, banks may close your recurring account.

Depositing sums lower than committed is not allowed in a recurring deposit. Some banks, though, allow deposits of amounts larger than what is committed. But here, the interest rate on the additional amount may depend on the prevalent recurring deposit rate and not the original rate.

Source: http://www.thehindubusinessline.com/features/investment-world/peonal-finance/article3666386.ece

Self Assessment

Fill in the blanks:

4. Accounts opened with the purpose of holding credit balances are referred to as .....; whilst accounts opened with the purpose of holding debit balances are referred to as .....
5. An account which may be operated any number of times on a working day without any limitation on the number and amount of withdrawals is known as .....
6. Overdraft facilities are given in case of ..... accounts.
7. The rate of interest payable by the banks on deposits maintained in savings accounts is prescribed by .....
8. The two types of demand deposits account are ..... & .....

5.4 Mandate and Power of Attorney

A Bank Mandate is a written order to a bank asking it to open an account, names the peon(s) allowed to sign cheques on behalf of the account bearer, and provides specimen signatures, etc.

Notes

It is a written document published by a bank to another bank requesting the second bank to allow a customer to open an account, carry out transactions and generally receive rights just like an existing account holder.

Power of Attorney is a legal official document giving one peon (called an "agent" or "attorney-in-fact") the power to act for another peon (the principal). The agent can have broad legal authority or limited authority to make legal decisions about the principal's property and finance. The power of attorney is often used in the cases of a principal's illness or disability, or when the principal can't be present to sign required legal documents for financial deals.

Did u know? There are two types of power of attorney:

1. ***General power of attorney:*** general power of attorney is carried out by a peon in favour of another to act on behalf of him generally. It may include management of property, court matter/litigations, sale of mortgage of property or any other act.
2. ***Special power of attorney:*** Special power of attorney is performed to do a particular act. Power of attorney holder is answerable to the principal and liable to give accounts to him.

5.4.1 Banke Lien

In terms of Section 171 of Indian Contract Act, a banker may, in absence of a contract to the contrary, retain as security for a general balance of account any goods bailed to them. This right of a banker is automatic and no agreement/contract is required and hence called general lien. Lien means right to retain goods in possession (but not to sell) until debit is discharged. But in case of bank, general lien tantamount to 'implied pledge'. He has the right to sell. Banker's right of general lien is available only over goods and securities received during normal coue of business but not over those received for specific purpose as an agent or as a trustee etc. It is also not available, if there exists any contract to the contrary. There may be particular lien over particular goods as per specific contract or even a negative lien i.e. an undertaking not to alienate a security without specific consent of the bank.

5.4.2 Right of Set off

Banker has right to combine two or more accounts. If one of them is in debit of customer in the same name and same right, care can be taken that:

- An account in the individual capacity of the customer showing debits balance cannot be combined with one in fiduciary capacity (i.e. trustee etc.) showing credit balance.
- Account really belonging to same peons, but in different names can be combined. Thus an account of a sole proprietohip concern may be combined with that in his peonal name. Two accounts, of a solicitor, one in his peons.
- Two accounts, of solicitor, one in his peonal name and other marked clients account cannot be combined.
- Two accounts one belonging to an individual and other jointly with someone, cannot be combined.
- The right can be exercised only when the debt is due.
- The right should exercise after giving due notice, unless a contract to the contrary exists.
- The right may be exercised before the garnishee order is made effective.

Notes

The aforesaid right to combine accounts is available to bank only. The customer cannot combine his two or more accounts and hence cannot except bank to honour cheque, drawn on one account, if balances are not sufficient in that account, but is so in the other one.

5.4.3 Garnishee Order and Attachment Order

When the debtor failed to pay the debt to his creditor, the latter may approach court for issuance of garnishee order on the banker of the debtor. A garnishee order is an order issue by court under provision of order 21 rules 46 of the code of civil procedure 1908. The order is in two parts – order nisi and order absolute. Order nisi is issued fit, directing the bank to stop payment in the account of the judgement debtor to explain as to why not the deposit of the particular peon is attached. This is because of the fact that the banker's right of set off takes precedence over garnishee order and therefore bank may require to avail the same. Order absolute is issued later, whereby entire balance in the account is attached, if the court is not satisfied with bank's explanation to order nisi. An order served on Head Office of a bank applies to all of its branches after reasonable period.

Garnishee order	Attachment order of revenue Authorities
1. May be issue for the entire balance or a specified amount.	1. Amount specifically mentioned.
2. Applies to outstanding on the date of receipt of the order not to subsequent credits in the account.	2. Applies to subsequent credits also
3. In case of joint account, if only one (or more but not all) is the judgment debtor, the joint a/c cannot be attached but reverse is true. In partnership a/c If judgment debtor is firm, partner (s) individual accounts may also be attached but reverse is not true.	3. Balance in joint accounts may be attached. The share of each of the account holder shall be, unless contrary is proved, presumed to be equal.

It is important to note that:

1. In case of clearing, when customer account credited, but he is the amount not allowed to withdrawn and therefore proceeds are not deemed to have been credited till realised. But if the customer is permitted to withdraw before the cheque is realize, it is deemed to have been purchased by the bank and garnishee order applies to such cases.
2. Both applies to debts due or accruing due or repayable at a fixed future date (viz. term deposit)
3. Unauthorized/undrawn balance in overdraft limits cannot be attached in both the cases.

Self Assessment

Fill in the blanks:

9. The peon to whom the power of attorney is given is known as a …….
10. The agent has a legal ……. to make legal decisions about the principal's property and finance.
11. The primary relationship, which flows from the essential function of a bank, is of …….
12. Lien is the right to …….
13. A garnishee order is issued by the …….
14. The right of set off can be exercised only when …….

Notes

Case Study

Customer Service

There is a branch opened 20 yea back in a Metro Centre. The area is a residential one and has several high profile and well to do people living in the area. Due to existence of such good custome several other banks, including a foreign bank, have opened their branches in the area.

On entering the branch one finds an atmosphere of orderliness with proper directions to custome. There is information about the various products of the bank displayed along with the requirements and formalities for availing such services.

On approaching the 'May I help you' counter the peon sitting there quickly deals with the custome and then looks after the work allotted to him. He is well aware of all the products of the bank and directs you to the right peon for the rest of the work. He provides you with a pre-prepared set of Account Opening Form for filling up and helps the illiterates in completing the formalities. He is also accepting cheques in clearing and transfer from the custome.

The branch has a regular practice of sending non-peonalised cards to custome after they have opened their accounts.

The drafts issued by the branch are delivered to custome in banks envelopes and normally delivered to custome in 20 minutes.

Every staff member of the branch has been given a set of queries raised by administrative offices/audito, relating to their job profile. This avoids unnecessary correspondence and other delay causing facto in customer service.

The branch has extended customer hou and has effectively marketed this feature to solicit custome. As such there are custome in the branch throughout the day.

The branch manager has started a practice of giving small mementos to the best employee of the branch every month.

Recently, the branch tied up with various principals of schools for opening accounts of students with photographs. These students were issued ATM cards immediately on opening of account. Due to this fact, the ATM hits have increased from 25 to 175 per day.

The branch follows the single window concept for all common services.

The branch has three floo and there are cash counte on all the floo. There is a senior citizen counter also on the ground floor.

There is another branch located in a posh colony. It has an ATM and the ATM cum debit cards have been issued haphazardly due to pressure from administrative offices. The branch was brought under Core Banking Solutions a long time back but there is no single window concept even for the most common services like SF, CA etc. A visit to the branch shows that the staff is moving around the branch chatting with each other but they are not busy due to work. The ATM hits are about 15 per day.

The peon sitting at the 'May I help you' counter is not up to date on the products and services of the Bank. He has been given the additional work of attending to telephone calls and also other miscellaneous work. The passbook updation counter is the fit casualty in case of absence/leave of staff.

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The Administrative Office keeps calling the branch for information regularly and both the branch manager and second man remain busy in providing such information. As such, they hardly have time for attending to custome.

The branch timings have been changed from 8.30 a.m. to 8.30 p.m. for the last 4 months but there has been no significant increase in business. In fact, very few custome are aware of the services offered during these extended hou.

The printer of the branch remains out of service most of the time. The staff is rude in attending to custome and they do not have any contingency plan in case of failure of connectivity. In fact, all the staff vanish from their seats when there is no connectivity.

The Accounts Opening Forms and other relevant forms are not available on the counter and the custome are seen moving from one counter to the other for obtaining cash deposit and withdrawal forms.

The managerial staff is not aware of even the basic menu options of the CBS software.

This branch is surrounded by Citibank and two other nationalized banks. There are more than 10 banks in one-kilometre radius.

A few office of the branch have a complaint with respect to PAF assessments rated by the final authorities. Though they are very hardworking and have contributed their might they were given only a good rating. This has affected their morale.

Question

As a Manager/Sr Manager posted at administrative office, you had visited both the branches along with your senior officials. Now the authorities have posted you at the second branch with a lot of hope and anticipation. Give a presentation on your strategy for the branch for the next one year.

Source: Iyengar. G Vijayaragavan, (2009), *"Introduction to Banking"*, Excel Books India.

5.5 Summary

- The Banking Regulation Act, 1949 defines 'Banking' as accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft order or otherwise (Sec.5b) and says that any company which transacts the business of banking is a 'Banking Company '(Sec.5 c).
- A customer is one who has a (Saving/Current/Fixed) deposit account irrespective of its debit or credit balance with the bank. Even an agreement to open an account makes one a customer.
- The various relationships between the bank and the customer are: Debtor- creditor, Trustee-beneficiary, Agent- principal, Bailor-bailee and Lesser-lessee.
- KYC or "Know your Customer" is a term used for customer identification which involves making reasonable efforts to determine true identity and beneficial ownehip of accounts, source of funds, the nature of customer's business etc., in turn, helping the banks to manage their risks cautiously.
- The framework of KYC norms mainly incorporates the following four key elements: Customer Acceptance Policy; Customer Identification Procedures; Monitoring of Transactions; and Risk management.
- Two types of demand deposit accounts are: current account and savings account; and Two types of time deposit account are fixed account and recurring deposit account.

Notes

5.6 Keywords

Attachment Order: an order from a court to hold a debtor's property to prevent it from being sold until debts are paid

Banke Lien: A charge that lets a bank have claim on assets in the banks possession. It can take and sell this property if default should occur.

Banking: As per Section 5(b) of Banking Regulation Act, 1949, banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, and order or otherwise.

Garnishee Order: The obligation of a banker to honour his customer's cheque is extinguished on receipts of an order of the court known as garnishee order issued under order 21 Rule 46 of civil procedure code.

KYC Norms: KYC is an acronym for "Know your Customer", a term used for customer identification process.

Lessor-Lessee: On hiring out of locker, bank becomes lessor and the hirer a lessee and the relationship is that of landlord and tenant.

Mandate: a written order to a bank that asks the bank to open an account, names the peon(s) allowed to sign checks on behalf of the account holder, and provides specimen signatures, etc.

Power of Attorney: A written authorization allowing a peon to perform certain acts on behalf of another, such as moving of assets between accounts or trading for a peon's benefit.

Recurring Account: Recurring deposit Account in a bank is a special account in which certain fixed amount can be deposited in every month for a specified period. The rate of interest in recurring deposit account is higher than savings account. After maturity period the total deposited amount along with accrued interest is paid to the account holder either in cash or by credit to the savings account in the same bank.

Right of set off: Right of set off is a statutory right and is available to any creditor even in the absence of express agreement. Right of set off means, where a customer has credit balance in one of his accounts and debit balance in another, the banker has a right to adjust credit balance with the debit balance and to arrive at the net sum due. Such right is known as "Right of set off".

5.7 Review Questions

1. Explain, in detail, the relation between the banks and the custome.
2. Briefly describe the concept of garnishee order.
3. What is attachment order? Explain in detail.
4. Differentiate between garnishee order and attachment order.
5. What are the objectives and components of KYC norms?
6. Explain the KYC framework.
7. Write a descriptive note on types of accounts.
8. Briefly describe mandate and power of attorney.
9. Write a short notes on:
    a. Banke Lien
    b. Right of set off
10. Explain termination of relationship.

Notes

Answe: Self Assessment

1. identity; address
2. prevent criminal elements from using the bank for money laundering activities
3. large amount of cash
4. deposit; loan
5. current
6. current
7. RBI
8. savings; current
9. agent
10. authority
11. debtor-creditor
12. retain goods in possession until debit is credited
13. court
14. there is no agreement between the banker and the customer

5.8 Further Readings

Books

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http://www.allbankingsolutions.com/Top-Topics/dep1.shtml

Notes

Unit 6: Type of Deposit Account

CONTENTS

Objectives

Introduction

6.1 Process of Opening Bank Accounts

6.2 Welcome Kit

6.2.1 Pay-in-Slip

6.2.2 Cheque Book

6.2.3 Pass Book

6.2.4 ATM cum Debit Card

6.2.5 Credit Card

6.3 Advantages of Bank Account

6.4 No Frills Account

6.5 Summary

6.6 Keywords

6.7 Review Questions

6.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Distinguish between the different types of deposit accounts
- Explain the procedure for opening bank accounts
- Define pay in slip
- Define cheque book, pass book, ATM card and credit card
- Discuss the advantages of bank account
- Explain no frill account

Introduction

In the previous unit, you have studied about the banker customer relationship, KYC norms, rights of the bankers and mandate and power of attorney. In this unit, you are going to learn about the different types of accounts, cheque book, pass book, ATM and credit card and no frill account.

A deposit account is a type of bank account that allows money to be deposited and withdrawn by the account holder. Deposit accounts are divided into two categories: (a) demand deposit; and (b) time deposit. Demand deposit is further classified into two – (i) savings account; and (ii) current account. Similarly, the two categories of time deposit are – (i) fixed deposit; and (ii) recurrent deposit.

Notes

6.1 Process of Opening Bank Accounts

The procedure for opening a bank account is as follows:

1. ***Application in the Prescribed Form:*** The first step towards opening a bank account is to apply to the concerned bank in the prescribed application form. These forms are printed and are available in the bank free of cost. The application form holds the data regarding the name of applicant, his occupation, full address, and sample signatures. Some banks also require a reference from the applicant.

2. ***Introduction of the Applicant:*** A relationship is established between a customer and a bank when he opens an account in a bank. The bank contracts to honour the cheque drawn by the customer as long as his account shows a credit balance. Though any person can apply to open an account in his name but the bank reserves the right to do so after it is satisfied about the identity of the customer. The banks generally insist on such person or business enterprise being introduced to the bank by an existing customer of the bank. The person introducing the account signs on the application form itself along with his full address. The bank may also call for references that would be consulted about the honesty, financial standing, integrity and reputability of the applicant.

3. ***Specimen Signature:*** When the bank is satisfied with the basic acknowledgements, it continues with the opening of the account. The applicant is asked to give his two or three specimen signatures on a prescribed form, generally a card, for the purpose of bank's record, so as to use them whenever the need arises. The specimen signatures are compared with the signatures on the cheques of the customers. If the two signatures differ, the bank can refuse to honour the cheque.

Notes To open a current account, following documents need to be submitted:

1. A certified copy of the resolution of the Board of Directors for opening of the account.
2. A copy of the Memorandum and Articles of Association of the Company.
3. A copy of the Certificate of Incorporation and Certificate of Commencement of business.
4. Specimen signatures of the persons authorized to operate the account.

4. ***To make the Initial Deposit:*** After all the formalities are completed, the applicant deposits the initial amount and the banker opens an account in the name of the applicant. Normally, the minimum amount to be deposited varies from bank to bank. Presently, many banks accept an initial deposit of ₹ 500/- for opening a new account.

After the whole procedure of opening a bank account is complete, a welcome kit is provided to the new account holder.

Self Assessment

Fill in the blanks:

1. The bank may calls for references for consulting about the ....., ..., ... and ..... of the applicant.
2. Most of the banks accept a deposit of ..... for opening a new account.

Notes

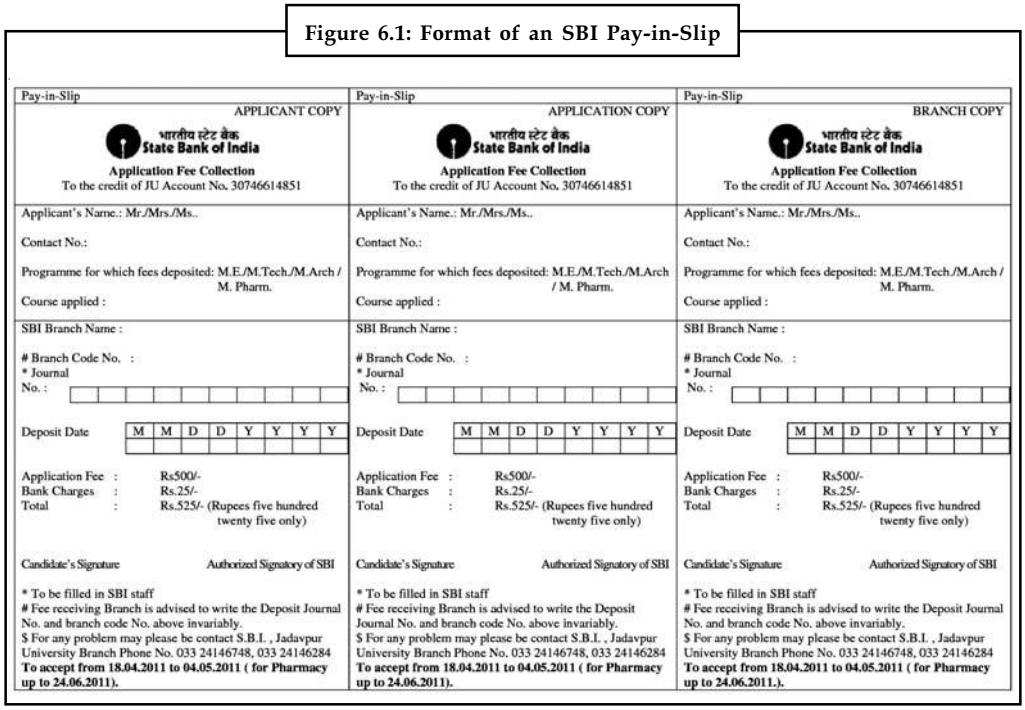
6.2 Welcome Kit

On opening a bank account, the different services offered to the customers are:

6.2.1 Pay-in-Slip

Pay-in-slips, also referred to as personalized invoices are a form used for paying money into a bank account with the same bank. Each pay-in-slip has a cheque stub which is returned to the depositor duly signed and sealed by the bank official. This source document, i.e. the cheque stub, relates to bank transactions and provides details regarding account number, date, amount deposited and name of the account holder.

Figure 6.1: Format of an SBI Pay-in-Slip



Pay-in-Slip — APPLICANT COPY

भारतीय स्टेट बैंक State Bank of India

Application Fee Collection
To the credit of JU Account No. 30746614851

Applicant's Name.: Mr./Mrs./Ms..
Contact No.:
Programme for which fees deposited: M.E./M.Tech./M.Arch / M. Pharm.
Course applied :

SBI Branch Name :
Branch Code No. :
* Journal No. :
Deposit Date M M D D Y Y Y Y

Application Fee : Rs500/-
Bank Charges : Rs.25/-
Total : Rs.525/- (Rupees five hundred twenty five only)

Candidate's Signature — Authorized Signatory of SBI

* To be filled in SBI staff
# Fee receiving Branch is advised to write the Deposit Journal No. and branch code No. above invariably.
$ For any problem may please be contact S.B.I. , Jadavpur University Branch Phone No. 033 24146748, 033 24146284
To accept from 18.04.2011 to 04.05.2011 (for Pharmacy up to 24.06.2011).

Pay-in-Slip — APPLICATION COPY

भारतीय स्टेट बैंक State Bank of India

Application Fee Collection
To the credit of JU Account No. 30746614851

Applicant's Name.: Mr./Mrs./Ms..
Contact No.:
Programme for which fees deposited: M.E./M.Tech./M.Arch / M. Pharm.
Course applied :

SBI Branch Name :
Branch Code No. :
* Journal No. :
Deposit Date M M D D Y Y Y Y

Application Fee : Rs500/-
Bank Charges : Rs.25/-
Total : Rs.525/- (Rupees five hundred twenty five only)

Candidate's Signature — Authorized Signatory of SBI

* To be filled in SBI staff
# Fee receiving Branch is advised to write the Deposit Journal No. and branch code No. above invariably.
$ For any problem may please be contact S.B.I. , Jadavpur University Branch Phone No. 033 24146748, 033 24146284
To accept from 18.04.2011 to 04.05.2011 (for Pharmacy up to 24.06.2011).

Pay-in-Slip — BRANCH COPY

भारतीय स्टेट बैंक State Bank of India

Application Fee Collection
To the credit of JU Account No. 30746614851

Applicant's Name.: Mr./Mrs./Ms..
Contact No.:
Programme for which fees deposited: M.E./M.Tech./M.Arch / M. Pharm.
Course applied :

SBI Branch Name :
Branch Code No. :
* Journal No. :
Deposit Date M M D D Y Y Y Y

Application Fee : Rs500/-
Bank Charges : Rs.25/-
Total : Rs.525/- (Rupees five hundred twenty five only)

Candidate's Signature — Authorized Signatory of SBI

* To be filled in SBI staff
# Fee receiving Branch is advised to write the Deposit Journal No. and branch code No. above invariably.
$ For any problem may please be contact S.B.I. , Jadavpur University Branch Phone No. 033 24146748, 033 24146284
To accept from 18.04.2011 to 04.05.2011 (for Pharmacy up to 24.06.2011.).

Source: www.docstoc.com

6.2.2 Cheque Book

Cheque is an official instrument in writing, containing an unconditional order, addressed to a banker, signed by the person who has deposited money with the banker, asking him to pay on demand a certain amount of money only to or to the order of certain person or to the bearer of instrument.

A cheque book contains a number of blank cheques printed with the name and account details of the account holder. They are a type of bill of exchange and were developed as a way to make payments without the need to carry large amounts of cash.

6.2.3 Pass Book

Pass Book is a book issued by Bank to an account holder. It is a copy of the account of the customer in the books of bank. The bank keeps the customer informed of the entries made in his

Notes

account through Pass Book. It is the customer's duty to check the entries and immediately inform the bank of any error that he may have noticed. The form of the Pass Book is given as:

Table 6.1: Format of a Pass Book

Messers ……..

Date	Particulars	Withdrawals Dr.	Deposits Cr.	Dr or Cr	Balance

Source: http://www.du.ac.in/fileadmin/DU/Academics/course_material/EP_14.pdf

Cash book is a supplementary book which records the receipts and payment of cash. With the help of cash book cash and bank balance can be checked at any point of time.

Difference between Pass Book and Cash Book

Any transaction has to be recorded in both the books i.e. Cash Book and Pass Book. But sometimes, it happens that a bank transaction is recorded only in one book and not recorded simultaneously in other book. This causes difference in the two balances.

Table 6.2: Differences between Cash Book and Pass Book

	Cash Book	Pass Book
1.	It is written by the depositor.	It is written by the bank but remains in the depositor's ownership.
2.	Money deposited is recorded on the debit side and money withdrawn on credit side.	Money deposited is entered on the credit side and withdrawn on the debit side.
3.	A cheque deposited for collection is recorded on the date of deposit.	It is recorded on the date when it is actually collected from the debtor's bank.
4.	A cheque when issued to a creditor is recorded on the date of issue.	It is recorded when it is paid by the bank to the creditor.
5.	Its debit balance shows cash at bank and credit balance shows bank overdraft.	Its debit balance shows bank overdraft and credit balance shows cash at bank.

6.2.4 ATM cum Debit Card

A card used in an Automated Teller Machine (ATM) to access a credit or a debit account to complete banking inquiries and fund transfers between accounts.

How Does an ATM card Work?

When a debit card is used, the transaction debits the amount of the transaction from the checking account, generally on the same day. A debit card can be used to get cash from ATM machines or have it swiped like a credit card at shops or restaurants or swipe it through a pay phone to make a call.

Notes

Caselet

Bank ATMs Stop Sucking in Cash after RBI Direction

Next time you go to an ATM to withdraw cash, don't worry about the banknotes getting sucked back by the machine if not collected immediately, as RBI has asked all banks to immobilise the 'cash retraction facility'.

At the same time, customers will have to be extra careful in collecting the cash dispensed by the ATM, as they cannot later claim the money from the bank, which was the case when this 'cash retraction facility' was in place at the ATMs. Most of the banks, including HDFC Bank, Axis Bank and Canara Bank, have already removed the cash retraction facility from all their ATMs, while the withdrawal process for this facility is underway for few remaining ATMs. As per RBI directions, the banks are communicating to their customers about the withdrawal of this facility, under which the cash goes back into the ATM machine if not collected within a stipulated time, which is generally 10-15 seconds, but varies from bank to bank.

The facility was initially implemented to avoid the cases of someone else getting the money, if the actual cardholder forgets to collect the withdrawn cash before leaving the ATM. However, RBI in the past one year has come across banks reporting several instances of frauds pertaining to misuse of cash retraction facility at the ATMs.

The typical modus operandi has been to hold on to a few pieces of notes in ATM machines that have cash retraction system, while allowing one or two pieces of notes to be retracted and then claiming non-receipt of cash.

Since retracted transactions are credited back to the customer's account, the balance in the fraudster's account remains unaffected even after collecting bulk of the delivered cash. The ATMs do not have the capability to count the pieces of retracted notes, thus leaving a loophole for committing such frauds.

Source: http://news.oneindia.in/2012/09/23/bank-atms-stop-sucking-in-cash-after-rbi-direction-1074654.html

Details on an ATM card

Figure 6.2: Front of an ATM Card

Source: http://news.thewindowsclub.com

Notes

Front of card contains following:

1. ***Name:*** Name of person authorized to use ATM card.
2. ***Card No:*** This is a unique 16-digit number embossed on card.
3. ***Validity:*** Card is valid for use from the day one receives it till the last day of the month/year (MM/YY) indicated in the card.
4. Visa Logo/Master Card Logo.

Figure 6.3: Backside of an ATM Card

Source: http://www.nodachi.co.uk/_images/_printmedia/large/sbi-gall02.jpg

Reverse of card contains:

1. ***Signature Panel:*** Panel with card holder signature.
2. Contact information / Help line Numbers.
3. ***Magnetic stripe:*** The most important and secured part of the card. It is made up of tiny iron-based magnetic particles in a plastic-like film. It stores card holder's name, and the card number, the expiry date, along with other bank-specific information

Did u know? The first magnetic stripe card ATM was installed at New York's Chemical Bank in 1969.

6.2.5 Credit Card

A plastic card issued by a bank, business, etc., for the purchase of goods or services on credit is known as a credit card. Credit card issuers usually remove interest charges if the balance is paid in full each month, but typically will charge full interest on the entire outstanding balance from the date of each purchase if the total balance is not paid.

Notes

Factors Determining Credit Card Interest in India

Depending on their credit worthiness, the credit card interest rate in India varies from bank to bank and even person to person. Still the banks setup credit card interest in India by taking into consideration the following factors:

1. ***Prime Lending Rate (PLR):*** This is the standard rate, based on which banks determine the interest rates of various loan products.

Example: A bank may decide to setup a credit card interest at a fixed rate of 0.5% over the PLR. This means that if the PLR increases or decreases, the card interest will vary accordingly.

2. ***Repo rate:*** This is the rate at which the Reserve Bank of India lends money to other commercial banks in the nation. Consequently, if this rate increases, the banks charge higher interest rates on its credit cards.

3. ***Reverse repo rate:*** This is the rate at which the RBI borrows from commercial banks. Therefore, if this rate is high, the banks have more funds and are willing to lower credit card rates.

Caution The credit card has a zero deposit rate but it charges fees for withdrawing money.

Cap on Credit Card Interest India

The Supreme Court enforced a judgment on capping credit card interest rates at 30 percent in 2008. According to Business Standard, the annualized range of interest charged by major banks in the absence of the interest cap was:

Table 6.3: Credit Card Interest Rate of Major Banks in India

Bank	Interest Rate (%)
Citibank	18.00- 42.00
ICICI	18.00- 49.36
Standard Chartered	23.88- 40.80
HSBC	33.00- 38.40
HDFC	36.60- 39.00

Parties Involved in a Credit Card Transaction

The various parties involved in a credit card transaction are:

1. ***Cardholder:*** The card bearer who makes the purchase, i.e. the consumer.

2. ***Card-issuing bank:*** The financial institution which issues the credit card to the cardholder. This bank bills the consumer for repayment and bears the risk that the card is used deviously. Cards issued by banks to cardholders in a different country are known as "offshore credit cards".

3. ***Merchant:*** The individual or business which accepts the credit card payments for products or services sold to the card bearer.

Notes

4. ***Acquiring bank:*** The financial institution which accepts the payment for the products or services on behalf of the merchant.
5. ***Independent sales organization:*** Resellers (to merchants) of the services of the acquiring bank.
6. ***Merchant account:*** This refers to the organization that the merchant deals with.
7. ***Credit Card association:*** An association of card-issuing banks such as Visa, MasterCard, American Express, etc. that set transaction terms for merchants, card-issuing banks, and acquiring banks.
8. ***Transaction network:*** The system that enforces the mechanism of the electronic transactions. It may be operated by an independent company, and one company may operate multiple networks.
9. ***Affinity partner:*** Some institutions lend their names to an issuer to attract customers that have a strong relationship with that institution, and get paid a fee or a percentage of the balance for each card issued using their name. For example, sports teams, universities, charities, professional organizations, and major retailers.

Credit Card Transaction Process

Once a credit card is used, a number of processes take place to complete its transactions.

1. ***Authorization:*** For making the payment the credit card holder makes purchases and swipes the card. The merchant submits the transaction to the acquirer (acquiring bank) and the acquirer verifies the credit card number of the holder and the transaction type. Authorization process generates an approval code which the merchant keeps secured as official record of the transaction.
2. ***Batching:*** Batching refers to keeping of the entire day's transactions together or in 'batches' before they are sent to the acquirer. These 'batches' are scheduled for submission at the end of business day. Clearance of those transactions which do not become part of the batch stays valid only for a period of time which is determined by the issuer. After the expiry of this time period the amount is returned to the credit card from where it was debited. Transactions that are submitted in the batch without prior authorizations can be those transactions that fall under the merchant's floor limit.
3. ***Clearing and Settlement:*** The clearing and settlement process begins with the merchant requesting to the acquirer for final transfer of transaction batch. This request is imparted through the credit card association which leads to the transfer of money from the customer's account to the merchant's account. The transaction charges are basically imposed to the account of the issuer.
4. ***Funding:*** Once the money reaches the acquirer, the amount is transferred from the acquirer account to the merchant's account. The merchant receives the amount from the acquirer after deduction of the transaction fee, popularly known as 'discount rate'. This is the fees that the merchant pays to the acquirer for processing the transaction.
5. ***Charge backs:*** In case of a dispute arising out of a transaction, chargeback comes into play. A chargeback is an event in which a purchase payment in a merchant account is held back due to a dispute relating to the transaction. Charge backs are mainly initiated by the cardholder. The issuer, in the event of a chargeback, returns the transaction to the acquirer for resolving the dispute. The acquirer, in turn, sends the chargeback to the merchant. The merchant then has the freedom of either accepting the chargeback or advocate it.

Notes

Task Visit your nearest bank, make an appointment with the manager and write down the various ATM and debit card problems he has solved.

Did u know? Some of the different types of credit cards available by banks are:

1. ***Standard Credit Card:*** The account holder has to top up the amount once the level of the balance goes down. An outstanding balance gets a penalty charge.
2. ***Premium Credit Card:*** It is also called the Reward Credit Card. Some examples are airlines frequent flier credit card, cash back credit card, etc.
3. ***Secured Credit Card:*** People without credit history or with tarnished credit can avail this card.
4. ***Limited purpose Credit Card:*** There is limitation to its use and is to be used only for particular applications.
5. ***Charge Credit Card:*** This requires the card holder to make full payment of the balance every month and therefore there is no limit to credit.
6. ***Speciality Credit Card:*** For business purposes enabling businessmen to keep their businesses transactions separately in a convenient way.
7. ***Prepaid Credit Card:*** Money is loaded by the card holder on to the card. It is like a debit card except that it is not tied up with a bank account.

Self Assessment

Fill in the blanks:

3 The benchmark rate, based on which, banks establish the interest rates of various loan products is known as .....

4 The rate at which the Reserve Bank of India lends money to other commercial banks in the nation is .....

5 Reverse repo rate is the rate at which the RBI .....

6 The financial institution accepting payment for the products or services on behalf of the merchant is known as .....

7 ..... refers to storing of the entire day's transactions together.

8 When a purchase payment in a merchant account is held back due to a dispute relating to the transaction, it is known as .....

6.3 Advantages of Bank Account

A bank account is a fund established in a bank by a customer who deposits money against which the customer may make withdrawals.

1. ***Bank account facilitates a safe custody of money:*** The bank is the custodian of cash. Whenever the account holders need the money, they can withdraw it depending upon the type of account.

Notes

2. ***Bank account helps in making payments:*** The bank account holder can make payment to third parties through his bank account. It may be regarding electricity bills, insurance premium, etc. The bank also makes direct payment on the instructions of the customer.
3. ***Bank account holders get advances and loans:*** The current account holder can obtain an OD facility from his bank. The savings account holders can also obtain loans to purchase computers and such other equipments. The recurring and fixed deposit account holders can get a loan up to 75% of the amount to their credit.
4. ***Bank account helps in smooth transactions:*** The bank account makes it possible for the businessmen to conduct their business operations smoothly in both domestic trade as well as foreign markets.
5. ***Bank account holders get a safe deposit locker:*** The bank provides safe deposit locker facility to its account holders to keep their valuables like gold jewellery, share certificates, property documents, etc.

Self Assessment

Fill in the blanks:

9 Bank account facilitates ..... money.

10 The recurring and fixed deposit account holders can get a loan up to ..... of the amount to their credit.

6.4 No Frills Account

In 2005-06, the RBI called upon Indian banks to design a 'no frills account', low 'minimum balance maintenance' account with simplified KYC (Know Your Customer) norms. Low income groups having no access to formal banking systems can well be brought under the umbrella of savings & credit – key factors which form the basis of financial inclusion. While there is no shortage of credit programs, the equally important savings aspect can rightly be nicknamed as the 'forgotten half of microfinance'. 'No frills' savings accounts appear capable, at least on paper, to cater to the small and irregular income flows of the poor.

The RBI has insisted the banking community to introduce the no-frills account to bring a large section of underprivileged people into the banking web. Even with 70,000 bank branches in the country, a large section of the population continues to remain credit-starved. The no-frills bank account is an innovative instrument to introduce the concept of banking to the underprivileged people. These no-frills accounts involve zero or a very low balance with limited transaction facilities.

In may 2012, Reserve Bank of India asked banks to drop the 'no-frills' label from the basic saving accounts as the terminology has become a stigma. It has asked banks to provide the zero balance facility in the basic banking accounts along with ATM-cum-debit cards without any extra charge.

Self Assessment

Fill in the blanks:

11 The no frills account was designed for the .....

12 The no-frills accounts ..... with limited ..... facilities.

Notes

Case Study

Bank of America

Innovation in services is rare. In financial services, the last big breakthrough was online banking, nearly a decade ago. In October, 2005, Bank of America (BAC) brought out a radically different product that broke the paradigm. It's called Keep the Change.

The concept solves a critical banking problem — how to get consumers to open new accounts. The product works like this: Every time you buy something with a BofA Visa debit card, the bank rounds up your purchase to the nearest dollar and transfers the difference from your checking into your savings account. It also matches 100% of transfers for the first three months, and 5% of the annual total, up to US $250 a year. Since the launch, 2.5 million customers have signed up for Keep the Change. Over 700,000 have opened new checking accounts and 1 million have signed on for new savings accounts.

How did Bank of America create Keep the Change? In the spring of 2004, it hired an innovation and design research firm in Palo Alto, Calif., to help conceive of and conduct ethnographic research on boomer-age women with children. The goal was to discover how to get this consumer segment to open new checking and savings accounts.

For the next two months, a team of five BofA researchers and four researchers from a West Coast consulting firm visited Atlanta, Baltimore, and San Francisco. They observed a dozen families and interviewed people on the streets. They watched people at home as they paid and balanced their checkbooks. They tagged along with mothers as they shopped at Costco, dined at Johnny Rockets, and made deposits in drive-through tellers.

Ray Chinn, senior V.P. for new product introduction, along with Faith Tucker, another BofA senior V.P., saw two themes emerge from the research. In Atlanta, the team met a mother who always rounded up her checkbook entries to an even dollar because it was quicker. People also rounded up their financial transactions because it was more convenient. The second realization: Many boomer women with children couldn't save. For some, it was a lack of money. For others, it was a matter of not being able to control their impulse buying.

In the summer of 2004, Chinn and Tucker put together a team of product managers, finance experts, software engineers, and operations gurus and held 20 brainstorming sessions. The team generated 80 product concepts, boiled them down to 12, and overwhelmingly favoured one: rounding up the financial transactions of consumers and transferring the difference to their savings.

The team created a Web-based cartoon that showed a woman buying a cup of coffee in a store for US $1.50. Then it displayed the rounding up and putting the 50 cents into a savings account. Tucker and Chinn tested out the cartoon and concept in an online survey of 1,600 consumers. The result? Sky-high scores on uniqueness. In December, 2004, Diane Morais, Chinn's and Tucker's boss, pitched the idea to the bank's consumer division and got the green light. The first challenge was a name. A woman in a focus group suggested Keep the Change. That stuck.

Three features were added to the original concept: (1) a summary of the rounded-up transactions in a consumer's checking and saving accounts, (2) a fail-safe feature that automatically prevented a transfer from pushing a customer's account into overdraft, and (3) a promotion to match the rounded-up transfers to savings up to US $250 a year.

Contd...

Notes

The next challenge was selling Keep the Change to the public. The team stumbled upon an approach in another focus group when someone suggested getting people to dig for change among the cushions of a couch. The bank tweaked the idea by creating a custom-made 20-foot-long red-velvet monstrosity that would really grab eyeballs.

To launch the product on Oct. 5, the bank staged a marketing event-cum-press conference in New York's Grand Central Terminal. The staff lugged the mega-couch into the station, stuffed it with coins and invited people to look for change. The bank sent replicas of the sofa to malls in Boston, Dallas, Los Angeles, and Miami and cosponsored events with the National Football League. Wives of NFL players and retired gridiron stars such as Ed "Too Tall" Jones were hired to show up at malls and dig for change. Proceeds were donated to charity. Bank of America ran TV commercials for the program during the winter Olympics. The bank continues to promote Keep the Change on its Web site, and it has bought ads with search engines.

Question

Analyse the case and write down the case facts.

Source: http://www.businessweek.com/stories/2006-06-18/case-study-bank-of-america

6.5 Summary

- The various steps involved in opening a bank account are: Application in the Prescribed Form, Introduction of the Applicant, Specimen Signature and To make the Initial Deposit
- Pay in slips, also referred to as personalized invoices are a form used for paying money into a bank account with the same bank.
- Cheque is an official instrument in writing, containing an unconditional order, addressed to a banker, signed by the person who has deposited money with the banker, asking him to pay on demand a certain amount of money only to or to the order of certain person or to the bearer of instrument.
- A cheque is said to be "dishonoured" or "bounced" when even though it is presented to the bank for payment, it is not encashed.
- Types of cheque on the basis of issuing: open cheque, crossed cheque, self cheque, pay yourself cheque & post dated cheque.
- Types of cheque on the basis of their functionality are: local cheque, at par cheque, banker's cheque, travellers' cheque & gift cheque.
- The parties involved in a credit card transaction are: Cardholder, Card-issuing bank, Merchant, Acquiring bank, Independent sales organization, Merchant account, Credit Card association, Transaction network and Affinity partner.

6.6 Keywords

No frill account: No Frills account is a basic banking account. Such account requires either nil minimum balance or very low minimum balance. Charges applicable to such accounts are low.

Pay in slip: Pay in Slip is a slip through which a person can deposit his money or cheque in his bank account. It is also called as Deposit Slip.

Prime Lending Rate (PLR): The interest rate that commercial banks charge their most credit-worthy customers on short-term loans.

Notes

Repo Rate: The rate at which the RBI lends money to commercial banks is called repo rate. It is an instrument of monetary policy. Whenever banks have any shortage of funds they can borrow from the RBI.

Reverse repo rate: Reverse Repo rate is the rate at which the RBI borrows money from commercial banks.

Specimen Signature: A specimen signature is an official "copy" of your signature that is kept on file and if needed in the future can be used to verify if a signature is genuine.

6.7 Review Questions

1. Write short notes on:
   (a) Pay in slip
   (b) Cheque
   (c) Cheque bouncing
   (d) Double crossing of cheques
   (e) Opening of crossing
   (f) Prime Lending Rate
   (g) No Frill account
2. Differentiate between:
   (a) General crossing & Special crossing
   (b) Pass book & Cash book
   (c) ATM card & Debit card
3. Explain the process of opening a bank account.
4. Describe the characteristics of a cheque.
5. Explain the different types of cheques.
6. Mention any 10 reasons for cheque dishonour.
7. Elaborate the proceedings in a cheque bounce case.
8. What are the bases for the classification of cheques? Explain in detail.
9. What are the details provided by an ATM card?
10. Explain the various factors which determine the credit card interest rates in India.

Answers: Self Assessment

1. Honesty, financial standing, integrity; reputability
2. ₹ 500
3. Prime lending rate
4. Repo rate
5. Borrows from commercial bank
6. Acquiring bank
7. Batching
8. Chargeback
9. Safe custody of
10. 75%
11. Low income groups
12. Involve low balance; transaction

6.8 Further Readings

Notes

Books

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Muraleedharan, D (2009), "*Modern Banking: Theory and Practice*", PHI Learning Pvt. Ltd.

Rajesh, R, Sivagnanansithi, T (2009), *"Banking Theory: Law and Practice"*, Tata McGraw Hill Publishing Company Ltd.

Shekhar, K C (2009), *"Banking Theory and Practice"*, Vikas Publishing House Pvt. Ltd.

Online links

http://www.publishyourarticles.net/eng/articles/procedure-to-open-a-current-account-or-a-saving-bank-account.html

http://kalyan-city.blogspot.com

http://mercantilelaws.blogspot.in/2012/05/general-crossing-and-special-crossing.html

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Notes

Unit 7: Loans and Advances

CONTENTS

Objectives

Introduction

7.1 Types of Loans

7.1.1 Term Loans (Outright Loans)

7.1.2 Cash Credit (CC)

7.1.3 Overdraft Facilities (O/D)

7.1.4 Discounting of Bills of Exchange (B/E)

7.2 Classification of Loans on the Basis of Activity

7.2.1 Priority Sector Lending (Directed Credit)

7.2.2 Commercial Lending

7.3 Classification of Loans – Purpose-wise

7.4 Principles of Good Lending

7.4.1 Safety

7.4.2 Liquidity

7.4.3 Diversification of Risks

7.4.4 Profitability

7.4.5 Purpose

7.5 Loan Procedure followed by Banks

7.6 Evaluating Consumer and Commercial Loans

7.6.1 Evaluating Consumer Loans

7.6.2 Evaluating Commercial Loans

7.7 Nature and Characteristics of Loans Granted by Commercial Banks

7.7.1 Characteristics of Commercial Bank Loans

7.8 Factors Influencing Loan Policy in a Bank

7.9 Summary

7.10 Keywords

7.11 Review Questions

7.12 Further Readings

Objectives

After studying this unit, you will be able to:

- Classify loans on several basis
- Explain principles of good lending

Notes

- Describe loan procedure followed by banks
- Evaluate consumer and commercial loans

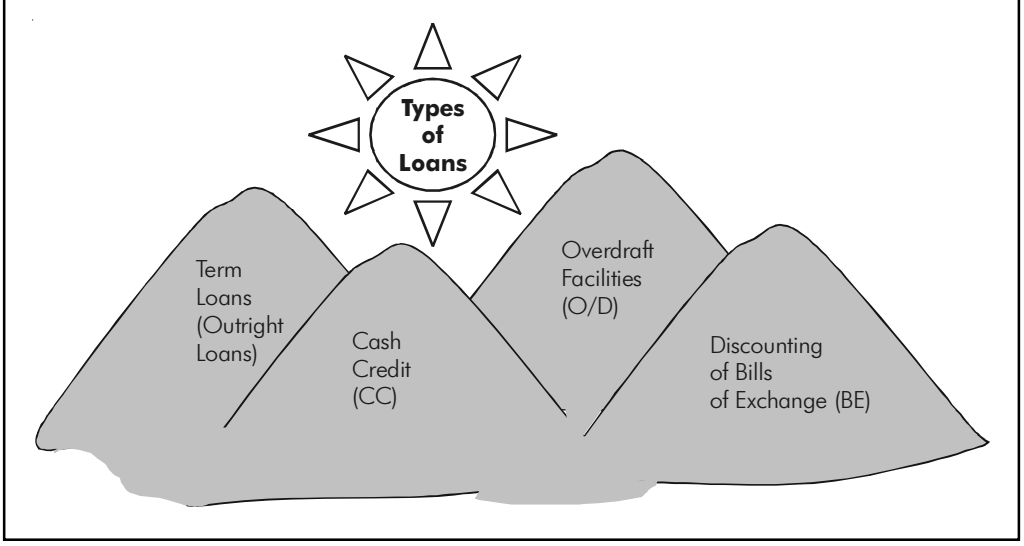
Introduction

In the previous unit, we dealt with the various types of deposit accounts including no-frills accounts. This unit will helps you to understand the various aspects related to loans and advances. The various section and sub section of this unit will also summarize the concept of evaluating consumer and commercial loans. Efficient management of Loans and Advances portfolio has assumed greater significance as it is the largest asset of the bank having direct impact on its profitability. In the wake of the continued tightening of norms of income recognition, asset classification and provisioning, increased competition and emergence of new types of risks in the financial sector, it has become imperative that the credit functions are strengthened. RBI has also been emphasizing banks to evolve suitable guidelines for effective management and control of credit risks.

7.1 Types of Loans

Banks, these days, extend loans and advances to their customers in the following ways:

Figure 7.1: Types of Loans



Source: C. Gulati Neelam (2010), "*Principles of Banking Management*", Excel Books.

7.1.1 Term Loans (Outright Loans)

Banks provide outright loans for a fixed period. The borrower pays interest on the entire amount he has borrowed.

- Term loans are the opposite of fixed deposits in the bank. The repayment of these loans is to be made in fixed, predetermined installments.
- This type of loan is normally given to the borrowers for acquiring long-term assets, which will benefit the borrower over a long period (exceeding at least one year). Purchases of

Notes

plant and machinery, constructing building for factory, setting up new projects fall in this category.

- Financing for purchase of automobiles, consumer durables, real estate and creation of infrastructure also falls in this category.

7.1.2 Cash Credit (CC)

In this case, the entire sanctioned (approved) amount of loan is not given to the borrower at one particular time. The bank opens an account of the borrower and allows him to withdraw the borrowed amount as and when he requires the money.

The bank charges interest, not on the amount of loan (CC) sanctioned, but on the actual amount withdrawn from the bank. Cash credit is very popular with Indian businessmen.

This account is the primary method of lending. Banks lend money against the security of commodities and debt. It runs like a current account except that the money that can be withdrawn from this account is not restricted to the amount deposited in the account.

7.1.3 Overdraft Facilities (O/D)

The word overdraft means the act of drawing more than the money deposited in the bank account. In other words, the account holder overdraws.

When a customer gets an overdraft facility from a bank, he is allowed to draw cheques in excess of the balance standing to his credit to the extent of the amount of overdraft.

Example: If a bank has allowed overdraft to the extent of ₹ 50 lakh to a businessman, he can draw cheques in excess of the amount of his own deposits with the bank to the tune of ₹ 50 lakh.

The bank charges interest only on the amount overdrawn. For a businessman, the overdraft facility is the easiest and most convenient method of borrowing funds from banks.

Difference between the Cash Credit Account and Overdraft

The difference is very minor and relates to the operation of the accounts. In the case of cash credit, a proper limit is sanctioned, which normally is a certain percentage of the value of the stock/debts pledged by the account holder with the bank.

Whereas the overdraft is allowed against a set of other securities including financial instruments like shares, units of mutual funds, surrender value of LIC policy and debentures, etc.

Did u know? **What are clean overdrafts?**

Those overdrafts which are granted against the supposed 'worth' of an individual.

7.1.4 Discounting of Bills of Exchange (B/E)

Discounting or purchasing the bills of exchange is an important form of bank lending. Bill discounting is a major activity of some of the smaller banks. The bank takes the bill drawn by borrower on his (borrower's) customer and pays him immediately deducting some amount as discount/commission.

Notes

The bank then presents the bill to the borrower's customer on the due date of the bill and collects the total amount. If the bill is delayed, the borrower or his customer pays the bank a predetermined interest depending upon the predetermined terms.

Thus, by discounting bills, the bank pays money to the creditor when he needs it and allows the debtor to make payment only when the bill is due for payment. Discounting of bills of exchange is, therefore, really important form of bank lending.

Tasks

1. Discuss agricultural loans by United Bank.
2. Practices of code on Lender's liability by Allahabad Bank.
3. Search and evaluate various types of loans granted by State Bank of India.

Self Assessment

Fill in the blanks:

1. Banks provide outright loans for a ……. period.
2. Term loans are the ……. of fixed deposits in the bank.
3. The word ……. means the act of drawing more than the money deposited in the bank account.
4. Sometimes, loans are named ……. the purpose for which they are granted.

7.2 Classification of Loans on the Basis of Activity

Another way to classify the loans is through the activity being financed. Viewed from this angle, bank loans are divided into:

1. Priority Sector Lending
2. Commercial Lending

7.2.1 Priority Sector Lending (Directed Credit)

The Government of India through the Reserve Bank of India (RBI) dictates certain type of lending on the banks operating in India. The RBI sets targets in terms of percentage (of total money lent by the banks) to be lent to certain sectors, which in the RBI's view do not have access to organized lending market or cannot afford to pay the interest at the commercial rate. This type of lending is called Priority Sector Lending.

Financing of small scale industry, small business, agricultural activities and export activities fall under this category. This is also called directed credit in Indian banking system.

Financing of priority sectors is done at a concessional rate of interest. Export finance is, in fact, available at a discount of 20% or more on the normal rate of interest to Indian corporates.

Notes Part of the cost of this concession is borne by the RBI by means of refinancing such loans at concessional rate.

Notes

Indian banks, thus, contribute towards economic development of the country by subsidizing the business activities undertaken by small entrepreneurs in the areas, which are considering "priority sector" by the RBI.

7.2.2 Commercial Lending

This lending is the basis of bread and butter of Indian banking.

Previously our nationalized banks have hugely indulged in "priority sector banking" yet it is the part of their loan portfolio which has kept them floating and help them to meet the costs.

Fresh and innovative products are being launched to facilitate the corporate customer who forms the heart of this business. There is big competition among banks to secure bigger share of this business.

At present, commercial loans are available for practically any kind of activity and also for both long and short-terms. Based on customer profile, these loans are of two types:

Corporate Loans

These loans are meant for corporate bodies, proprietorships, partnerships and HUFs engaged in any legal business activity with the object of earning profit. Banks lend to such entities on basis of:

1. Strength of their balance sheet,
2. The length of cash cycle, and
3. The products available with individual banks.

Lending on the Strength of Balance Sheet

Banks analyse the audited balance sheets of the potential borrowers to evaluate their needs and also their capacity to utilize the loan.

Caution Prospective borrowers are required to furnish their financial details to the bankers along with application for the loan. This application is processed and a line of credit (limit) is allowed to the borrower.

The overall limit (line of credit) is structured into various types of facilities or accounts–each with its own limit within the overall line of credit – depending upon the needs of the customer. The borrower is then asked to complete other formalities, like the bank's standard documents, surrender the security or title to the security to the bank and open suitable accounts (mostly cash credit accounts with different underlying securities) with the bank. Thereafter, the borrower can operate this account within the limit (line of credit).

Length of Cash Cycle

Length of cash cycle would mean the time, within which the cash gets converted into goods, then goods are sold either for cash or if sold on credit the debt is realized after some time. The average period of the whole activity is called cash cycle.

Notes

The Products available with Individual Banks

There are many types of loan products available for business community. The loans are structured depending upon the need of the client and the product available with the lending bank.

Retail Loans

This type of lending is meant for very small entrepreneurs as well as individuals who are engaged in some economic activity. Loans are given on the strength of the earnings of the borrower with an eye on the repaying capacity.

Loans for Purchase of Automobiles/Consumer Durable Items

Most banks nowadays have products for financing the purchase of automobiles and other consumer durable items. The quantum of loan granted is generally determined by the repayment capacity of the borrower.

Notes Most banks apply their own method to calculate the maximum monthly repayment capacity of a person.

Thus, a loan for which Equated Monthly Instalment (EMI) is within the capacity of borrower is considered the outer limit for a person. The bank gladly finances to this extent for the purchase of an automobile or any other consumer durable item.

Banks judge the monthly income of borrower with reference to:

1. The latest salary certificate from the employer (in case of employees), or
2. The last year's income tax return (in case of self employed persons).

Some important points to remember for the borrower:

1. While considering a loan of such nature, check whether the interest is payable on the entire amount for the entire period or on the outstanding amount only.
2. Check the rest, i.e., the frequency at which the interest will be debited or charged to his account. Reject any frequency less than a quarter.
3. Mostly there are hidden charges called service charges or appraiser charges, which inflate the cost to borrower. The borrower should carefully check these before taking a loan.
4. The documents should be read carefully to check if there are such clauses and conditions which tilt the balance heavily in favour of the bank/finance company.

Self Assessment

Fill in the blanks:

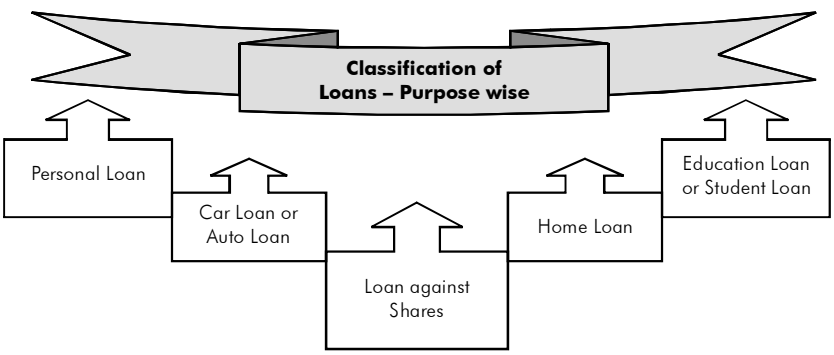
5. RBI's view ……. have access to organized lending market.
6. Financing of priority sectors is done at a …… rate of interest.
7. …….. lending is the basis of bread and butter of Indian banking.

Notes

7.3 Classification of Loans – Purpose-wise

Almost all the banks in our country give the following loans:

Figure 7.2: Purpose-wise Classification of Loans



Source: C. Gulati Neelam (2010), "*Principles of Banking Management*", Excel Books.

1. ***Personal loan/Consumer loans:*** Consumer loans granted for personal (medical), family (education, vacation), or household (extension, repairs, purchase of air conditioner, computer, refrigerator, etc.) use, as opposed to business or commercial use. Generally, these loans are used for debt consolidation, or to pay for vacations, education expenses, or medical bills, and are amortized over a fixed term with regular payments of principal and interest. Such loans are either unsecured, or secured by the asset purchased or by a cosignor (guarantor). Unsecured loans (called signature loans) are advanced on the basis of the borrower's credit-history and ability to repay the loan from personal income. Repayment is usually through fixed amount installments over a fixed term. Also called consumer loan.

2. ***Car loan or auto loan:*** It is a personal loan to buy a car. Almost all the banks give car loan, which is also termed as auto loan. It is one of the fast moving financial products of banks. Car loan/auto loan are sanctioned to the extent of 85% upon the ex-showroom price of the car with some simple paper work and a small amount of processing fee.

3. ***Loan against shares:*** Loan against shares can be obtained very easily. It is given on basis of a liquid guarantee.

4. ***Home loan:*** It is a personal loan to buy a house. Home loan is the latest craze in the banking sector with the development of the new infrastructure. Now people are moving to township outside the city. More townships are coming up to meet the demand of 'house for all'.

Notes The RBI has also liberalised the interest rates on home loans in order to match the repayment capability of even middle class people.

Almost all banks are dealing in home loans. SBI, ICICI, HDFC, HSBC are leading home loan providers.

5. ***Education loan:*** Till some years back, higher education and quality education was not affordable to many brilliant students because of the financial problems. There was no

Notes

alternative but to jump into the job market a shade too early. And this led to untimely end of budding talents and their forceful transformation into to mediocrity (less capable individuals).

Scholarships were there, but those were so less in numbers that only luckier few could avail of them. But now the scene has changed drastically. The boom in the banking sector has led to release of large amount of funds for education loans. Now, education loans are easily available from various banks in India and this change is encouraging more and more students to take up higher education despite their financial shortcomings.

Nationalized banks as well as private banks have come up with various educational loan schemes that students can benefit from. The current scenario is such that immediately after the results announcements of CAT or PMT/IIT-JEE, the representatives of the banks queue up for giving education loans to the successful candidate even with very flexible conditions. This scenario is certainly helping good students to pursue higher education and realize their dreams.

Some banks that give education loans are as follows:

1. Allahabad Bank
2. Bank of Baroda
3. Punjab National Bank
4. Indian Bank
5. State Bank of Mysore
6. Andhra Bank
7. Bank of India
8. State Bank of Indore
9. Karnataka Bank
10. Bank of Maharashtra
11. Bank of Rajasthan
12. Canara Bank
13. Catholic Syrian Bank
14. Central Bank
15. Dena Bank
16. Development Credit Bank
17. Federal Bank
18. HDFC Bank
19. IDBI
20. Mysore Bank, etc.

The education loan normally may cover:

1. The college, school or hostel fee.
2. Expenses for buying books, instruments or uniform.
3. Exam laboratory or library fee.

Notes

4. Money for buying computer for pursuing computer programming.
5. Travel and lodging expenses will also be covered by the loan.
6. Caution deposit, refundable deposit or building fund.
7. Any other cost essential for studying the program.

Self Assessment

Fill in the blanks:

8. The RBI has also ..... the interest rates on home loans in order to match the repayment capability of even middle class people.
9. ..... loans are used for debt consolidation, or to pay for vacations, education expenses, or medical bills, and are amortized over a fixed term with regular payments of principal and interest.

Caselet

Gold Loans: RBI Favours Banks over NBFCs

A paper on gold loans by a Reserve Bank of India (RBI) working group favours banks over Non-banking Financial Companies (NBFC).

Currently, NBFCs devise lending formulae after taking into account the overall value of gold jewellery, which includes making charges, manufacturing loss, tax, etc. According to the paper, current RBI guidelines allow NBFCs to tweak the calculating method according to their convenience, without the overall lending exceeding 60 per cent of the loan-to-value (LTV). Though the formula recommended by RBI raises the LTV, overall lending declines slightly below that using the current formula (with 60 per cent of LTV), as this doesn't allow NBFCs to include making charges, tax, etc. in the overall value of gold.

In the revised recommendations, RBI mandates NBFCs to consider only the value of the metal. Hence, the overall lending comes down marginally.

"The recommendation by the committee for an LTV increase is incrementally neutral for the sector, though it provides much-needed clarity to gold loan NBFCs," said Pankaj Agarwal, an analyst with Ambit Capital.

"Moderation in the operations of gold loan NBFCs may provide increased opportunity to banks to further enhance their share in the gold loan market. For this, banks would have to reorient their business models and customer services to fully tap the business opportunities in the gold loan market, as they may still lack the speed to deliver to borrowers whose needs are catered to by gold loans NBFCs so far," the paper said.

Data compiled by RBI (from NBFCs and banks) showed of the total gold loans outstanding at the end of March 2012, 72 per cent were provided by banks, while the rest were given by gold loan NBFCs. However, the share of NBFCs doubled from 13 per cent at the end of April 2008. Thus, annually, the share of the NBFCs increased by about three percentage points.

In recent years, there has been a growing demand for gold loans. On an annual basis (considering a three-year moving average), gold loans in India grew 60-70 per cent in the

Contd...

Notes

last four years. The growth in gold loans from NBFCs has been particularly high, albeit marked by fluctuations.

In 2009-10, the annual growth in gold loans from NBFCs soared to about 140 per cent, before recording fluctuations and later, a decline.

Of late, annual average growth in gold loans from banks has been rising. Since August 2009, when it fell to 35.0 per cent, it rose steadily to 76.0 per cent by February 2012.

Among the challenges banks face is the lack of standard procedures, which a report by the Bank of America Merill Lynch termed vital. Also, RBI plans to put a cap on loan rates, another factor that may hit NBFCs. The current cap for microfinance companies stands at 24 per cent. Given the secured nature of gold loan products, Bank of America Merill Lynch believes the cap may be kept at the same level or below the cap for microfinance institutions. This may take a toll on net interest margins.

Source: http://www.business-standard.com/article/markets/gold-loans-rbi-favours-banks-over-nbfcs-113010600053_1.html

7.4 Principles of Good Lending

Lending is the most profitable business of a commercial bank, but it is highly risky too. Leading is always accompanied by the credit risk arising out of the borrowers' default in repaying the money. A banker should, therefore, manage his loan business in a safe and profitable manner. He should take all the necessary precautions to minimize the risk associated with the grant of a loan. In considering a loan proposal, he should bear in mind certain general principles of lending.

1. Safety
2. Liquidity
3. Diversification of Risks
4. Profitability
5. Purpose

These principles help him to set up some credit standards for evaluation of the loan applications of borrowers. Some of these principles are incompatible, e.g., liquidity and profitability, but a judicious banker is able to strike a satisfactory compromise between these two.

These principles are given below:

7.4.1 Safety

The safety of funds is the most important guiding principle of a banker. The safety of funds implies that the borrower would repay the principal sum and the interest thereon in the manner and on the conditions provided for in the loan agreement.

While lending out funds, a banker should ensure that:

1. The loan to a particular borrower does not involve any avoidable risk of nonpayment.
2. A bank must follow an aggressive policy of lending in its bid to maximize earnings; but it has also to be defensive at the same time because it cannot afford to lose the people's (depositors) money.
3. A banker should always take a calculated risk.

Notes

4. Banker must always insist upon collaterals, margins and guarantees in addition to the personal promise of the borrower.

Thus, a bank should lend money after ensuring its full safety of repayment; otherwise the banker will not be in a position to repay the deposits. Consequently, he will lose public confidence and thus subsequently may get ruined.

7.4.2 Liquidity

Liquidity means ease of conversion of an asset into cash. As a major part of commercial bank liabilities is payable either on demand or on short notice, the banker should ensure that the loans are liquid. Liquidity, thus, signifies the readiness with which the bank can convert its assets into cash with no or insignificant (small) loss.

1. A loan will be liquid if it has been given for a short period to finance some purchases of stock, raw materials, etc.
2. A banker should give short-term advances which can be recalled in time to satisfy the demands of the depositors.
3. Bank should not lend short period funds for a long time. As in that case, the loans and advances will tend to be less liquid, and it would be a great problem for it to realise cash in case of an emergency.
4. Loans, to be liquid, should be given against the security of quickly realizable assets so that in case the borrower defaults in repayment; these might be readily converted into cash.
5. Cost of borrowing from the Reserve Bank of India:
   (i) It is related to the net liquidity ratio.
   (ii) Net liquidity ratio is the ratio of the net liquid assets of the borrowing bank to its aggregate demand and time liabilities.
   (iii) The net liquidity ratio of a bank must be equal to the specified limit or above it, so that it may obtain a loan from the Reserve Bank at the bank rate.
   (iv) With every one percent drop in the net liquidity ratio of the borrowing bank, the cost of lending by the Reserve Bank goes up by one percent.

7.4.3 Diversification of Risks

A banker should adhere to the principle of diversification (spread) of risks while lending funds. Diversification implies the dispersal (lending) of funds over a large number of borrowers and borrowing firms situated in different parts of the country. In other words, a bank should not lend money to a few entities. Also, a bank should lend money in different types and ranges of interest whereby some are risky, some with less risk and some risk-free.

Purposes of this principle are:

1. Minimizing the risk inherent in the grant of loans.
2. It is a defensive policy to protect the bank against risk.
3. Also, a device for increasing the average return on a fund that might otherwise, for the sake of safety, be confined to risk-free assets providing little or no return.
4. A banker should remember that if he puts all his eggs in one basket he may lose all of them together at a time. In view of this, he should avoid concentrating the bank's funds in a few customers. If these few customers do not pay then the bank may go bankrupt.

Notes

5. A bank must offer advances to different firms belonging to different industries, which are situated over different geographical areas, so that he may not be badly affected by the failure of one industry or a few big borrowers.
6. Maturity diversification: The most important form of diversification is maturity diversification. The loan portfolio should be such that different loans and advances have different maturity time. This results in continuous repayments throughout the year and thereby maintains liquidity of bank.

7.4.4 Profitability

Equally important is the principle of profitability. The difference between the lending and borrowing rates constitutes the gross profit of the bank. Banks need to earn profit for several reasons:

1. Like other economic entities, banks must earn sufficient income to pay interest to the depositors in order to meet establishment charges, pay dividends to owners, and retain a portion of the income for the future growth, expansion and contingencies.
2. Lending rates are affected by the bank rate, interbank competition and interbank agreements, where they have been agreed.
3. No banker will and should ordinarily think of an advance without a satisfactory margin between the lending and borrowing rates.
4. Different rates are charged, depending on the credit risk involved in the lending to different borrowers, type of loans, the nature of security, the mode of charge, the margin requirement.
5. Advances should be given to customers after proper enquiry about the risk and credibility associated with him. Also, proper guarantees must be taken.

A prudent banker will avoid making profit at the expense of the liquidity and safety of his capital. Thus, within the limits of liquidity, safety, and the national policies as laid down by the government and the Central Bank, a banker should strive for accomplishing the objective of profitability.

7.4.5 Purpose

Bankers should always inquire about the purpose for which the loan is taken. As a matter of fact, the safety and liquidity of loan depends on the purpose for which it will be put.

1. An advance given for productive purposes in all probability will be repaid because the grant of the loan will generate additional income for the borrower to enable him to repay it.
2. An advance made for nonproductive and speculative purposes is subject to greater credit risk because the purpose for which the loan was sought would in no way improve the repaying capacity of the borrower. Borrower may or may not be able to pay.
3. There are chances that funds borrowed for a productive use may be used for speculative purposes. The banker (as far as possible) should, therefore, take follow-up steps to see that the end-use of credit is not for a purpose other than for which it is taken.

Thus, a banker should avoid giving loans for wasteful expenditure, social functions and speculative transactions.

Notes

Self Assessment

Fill in the blanks:

10. A bank must follow an ……..policy of lending in its bid to maximize earnings.

11. Net liquidity ratio is the ratio of the net liquid assets of the borrowing bank to its aggregate demand and time ……..

7.5 Loan Procedure followed by Banks

Banks provide financial assistance to its customers in the form of loans, advances, cash credit, overdraft and through the discounting of bills. The procedure of applying for and sanction of loans and advances differs from bank to bank. However, the steps which are generally to be taken in all cases are as follow:

1. ***Filling up of loan application form:*** Each bank has separate loan application forms for different categories of borrowers. When you want to borrow money from a bank, you will have to fill up a loan application form available with the bank free of cost.

   The loan application form contains different columns to be filled in by the applicant. It includes all information required about the borrower, purpose of loan, nature of facility (cash-credit, overdraft etc.) required, period of repayment, nature of security offered, and the financial status of the borrower. A running business limit may be required to furnish additional information in respect of:

   (a) Assets and Liabilities

   (b) Profit and loss for the last 2 to 3 years.

   (c) The names and addresses of three persons (which may include borrowers, suppliers, customers and bankers) for reference purposes.

2. ***Submission of form along with relevant documents:*** The loan application form duly filled in should be submitted to the bank along with the relevant documents.

3. ***Sanctioning of loan:*** The bank scrutinizes the documents submitted and determines the credit worthiness of the applicant. If it is found to be feasible, the loan is sanctioned. If the loan is for ₹ 5000 or less, normally the Branch Manager himself can take the decision and sanction the loan. In case the amount of loan is more than ₹ 5000, the application is considered at regional, zonal or head office level, depending on the amount of loan.

4. ***Executing the Agreement:*** When the loan is sanctioned by the bank and the borrower is informed about it, he will have to execute an agreement with the bank regarding terms and condition for the amount of loan raised.

5. ***Arrangement of Security for Loan:*** The borrower will now arrange for security against the loan. These securities may be immovable properties, shares, debentures, fixed deposit receipts, and other documents, like, Kisan Vikas Patra, National Savings Certificate, as per agreement.

When the borrower completes all the formalities, he is allowed to get the amount of loan/advance/overdraft as sanctioned by the bank. In case of 'discounting of bills', the bank credits the amount of bill to the customer's account before the realization of the bill and thus, makes available the fund. In case, the bill is dishonoured on due date, the amount due on the bill together with interest and other charges are payable by the party whose bill is discounted.

Notes

Self Assessment

Fill in the blanks:

12. The procedure to apply for and sanction of loans and advances ..... from bank to bank.
13. Loan Application forms are available with the bank ..... of cost.
14. The Bank determines ..... of the applicant before sanctioning loan.

7.6 Evaluating Consumer and Commercial Loans

Consumer loans, while technically any type of loan extended to a single customer, not a business, are normally associated with personal and unsecured loans. These loans can vary in structure, but most consumer loans share some general characteristics. As consumer spending continues to rise, more and more lenders have entered the market, so your options for consumer loans have increased. Before signing on for one of these loans, you must know how to evaluate each offer.

7.6.1 Evaluating Consumer Loans

There are many criteria banks and other financial institutions are looking at when someone applies for a consumer loan in order to accept, refuse or accept "with condition" the demand. Here is the list of 5 criteria, in order of importance that banks base their decisions on for consumer loans:

1. ***Personal Credit:*** The personal credit, such as the beacon FICO scores, is the number one criteria by importance. The personal credit is the payment habit of the consumer with their past and current creditors. The report represents, to the company lender, a projection of the applicant's behaviour on their future loan.

   "History is bunk" Henry Ford would say, but those who proved to be good payers to their old lenders will have better chances of being accepted for new loans. On the other side, applicants with bad credit that include collections, severe late payments or bankruptcies will have their files dismissed from further evaluation; these types of applicants often mean future problems for banks.

2. ***Stability:*** This is the time an individual takes to be established in society.

   (a) *Time at their job:* The first aspect of stability is the time at their job. The longer the time someone spends at their current job, the stronger they will be settled professionally and the lower their chances of becoming unemployed. In the world of credit, employment guarantees income, the main source for debt payment. The loss of a job often leads to problem executing payments and increases the risk of defaulting. Regular payments made on time are more assured when a person has job stability.

   (b) *Time at present address:* The time at present address is one of the most neglected and unknown aspect by applicants. However, many statistics and analysis showed that someone who has lived only for a short period of time at their current address has more chances of moving away and leave their debt behind. On the other hand, having lived at the same address for a long time improves the chances of obtaining credit. This is weighted considerably in the final decision.

Notes

(c) *Homeowner/Tenant:* The status of homeowner and tenant plays a definite role in stability. For obvious reasons, a homeowner has more responsibilities and their risk of moving away is smaller, as opposed to tenants, known to be less predictable. Being a homeowner is a positive in term of stability.

(d) *Debt Ratio:* The debt ratio is the ratio between monthly payments of the debt, including the new loan, and monthly gross income. The limit of an acceptable debt ratio differs from banks to banks and the type of credit requested, but normally ranges between 35% and 50%. The level of acceptability also depends on the first two criteria (personal credit and stability), but a debt ratio too high can stop a loan from being accepted, no matter how good the credit or stable the applicant is.

(e) *Net Value:* The net value is the financial equity of an individual, which are the personal assets minus the personal debt. The assets taken in consideration by banks are the verified real estate market value of their home and a portion of personal investments, where 50% to 80% of their value is considered based on risk level. On very rare occasions cars and other vehicles are considered assets, as they constantly devaluate.

The biggest asset is normally the real estate. However, these assets are the least liquid; selling the house to pay some debt is really the last resort. Therefore, a decision cannot be based on the net value before the first three criteria. It is more of an indicator of how deep pocketed the applicant is.

If the person has a good equity on their property, it will weight considerably in the credit application. Not necessarily because the property can be included as a guarantee, but great equity always gives someone the possibility of obtaining additional indebtedness on the mortgage, which will help face financial obligations.

(f) *Occupation and Personal Status*

(i) Professional Status: The occupation is taken into consideration in a credit application. Doctors, lawyers, engineers and other professionals will be more valued than self employed workers, the nature of their work being more unpredictable, and blue collar workers, because it is more difficult to turnaround in case of job loss.

(ii) Personal Status: The age of the applicant is the main issue, even though it is considered discriminatory, the lenders will still take it into consideration. The chances of default are much higher under 30 years old than 50 years old and up, considered the most desirable age bracket. Less than 20 years old is the highest risk.

These points determine the interest rate and the goods that will be taken as collateral. In the case of personal loan, line of credit or other loan where the decision is based only on the individual applicant, the rate or the guarantee will fluctuate based on the answer given in the first five criteria. In the case of credit cards, these criteria will not be as important since the interest rate is already high, reducing some risk of monetary loss for banks. The same principle applies on a mortgage or the financing of a vehicle, where collateral can lower the acceptance barrier.

In general, banks are looking for a consistency of payments on the debt, therefore a guarantee of a good cash flow towards them. The lesser importance of the other criteria reflects a less immediate guarantee of payment. If we interpret their analysis based on the cash flow, banks are first looking at the reliability of the payer, next at the regularity of their payments, their payment capacity, and finally, the bank's capability to get their missing payments in case of default. If one criterion is not positively fulfilled, the next, lesser important one will not be taken into consideration.

Notes

7.6.2 Evaluating Commercial Loans

When evaluating loan requests, bankers can make two types of errors in judgment. The first is extending credit to a customer who ultimately defaults. The second is denying a loan to a customer who ultimately would repay the debt.

It is often difficult to identify dishonest borrowers. The best indicators are the borrower's financial history and personal references. Just because a company has audited financial statements, however, does not mean the reported data are not manipulated. Management has considerable discretion within the guidelines of generally accepted accounting principles and thus can "window dress" financial statements to make the results look better.

Loan proceeds should be used for legitimate business operating purposes. Speculative asset purchases and debt substitutions should be avoided. The amount of credit required depends on the use of the proceeds and the availability of internal sources of funds. The required loan amount is a function of the initial cash deficiency and the pattern of future cash flows.

Loans are repaid from cash flows. Credit analysis evaluates the risk that a borrower's future cash flows will not be sufficient to meet mandatory expenditures for continued operations and interest and principal payments on the loan. The four basic sources of cash flow are: the liquidation of assets, cash flow from normal operations, new debt issues, and new equity issues.

It is not by chance that the question of collateral is the last question to be addressed. In general, a loan should not be approved on the basis of collateral alone. Collateral improves the bank's position by lowering its net exposure. It does not improve the borrower's ability to generate cash to repay the loan. Virtually any asset, or the general capacity to generate cash flow, can be used as collateral.

From a lender's perspective, however, collateral must exhibit three features. (1) Its value should always exceed the outstanding principal on a loan. (2) It must have a ready market for sale. (3) A lender must be able to clearly mark collateral as its own.

There is a four-stage process for evaluating the financial aspects of commercial loans:

1. ***Overview of Management, Operations, and the Firm's Industry:*** Before analyzing financial data, the analyst should gather background information on the firm's operations, including specific characteristics of the business and intensity of industry competition, management character and quality, the nature of the loan request, and the data quality.

2. ***Common Size and Financial Ratio Analysis:*** Common size ratio comparisons are valuable because they adjust for size and thus enable comparisons across firms in the same industry or line of business. Most analysts differentiate between at least four categories of ratios: liquidity, activity, leverage, and profitability. Liquidity ratios indicate a firm's ability to meet its short-term obligations and continue operations. Activity ratios signal how efficiently a firm uses assets to generate sales. Leverage ratios indicate the mix of the firm's financing between debt and equity and potential earnings volatility. Finally, profitability ratios provide evidence of the firm's sales and earnings performance.

3. ***Cash Flow Analysis:*** Accounting standards mandate that the statement of cash flows be divided into four parts: operating activities, investing activities, financing activities, and cash. Operations section includes income statement items and the change in current assets and current liabilities (except bank debt). Investments section includes the change in all long-term assets. Financing section includes payments for debt and dividends, the change in all long term liabilities, the change in short term bank debt, and any new stock issues. Cash section includes the change in cash and marketable securities. The key element in the analysis is to determine how much cash flow a firm generates from its normal business

Notes

activity, that is, cash flow from operations. This cash flow must be sufficient to make interest and principal payments on debt. It may differ substantially from reported profits.

4. ***Financial Projections:*** Projections of the borrower's financial condition reveal what the loan proceeds are needed for, how much financing is required, how much cash flow can be generated from operations to service new debt, and when, if at all, a loan can be repaid. In order to understand the range of potential outcomes, an analyst should make forecasts that incorporate different assumptions about sales, inventory turnover, the level of interest rates, and the growth in operating expenses. Pro forma analysis is a form of sensitivity analysis. At a minimum, three alternative scenarios or sets of assumptions should be considered: a best case scenario, a worst case scenario and a most likely scenario.

Self Assessment

Fill in the blanks:

15. The key element of cash flow analysis is to determine how much cash flow a firm generates from its normal business activity, that is, cash flow from ……..

16. The biggest asset is normally the ……..

7.7 Nature and Characteristics of Loans Granted by Commercial Banks

Let us discuss the nature and characteristics of commercial bank loans:

1. ***Secured loan:*** A secured loan is a loan in which the borrower pledges some asset (e.g., a car or property) as collateral (additional security) for the loan.

2. ***Unsecured loan:*** Unsecured loans are monetary loans that are not secured against the borrowers assets. These may be available from financial institutions in many different ways or marketing packages like:

   (a) Credit card debt

   (b) Personal loans: Nature of Loans Granted by Commercial Banks

   (c) Bank overdrafts

   (d) Credit facilities or lines of credit

   (e) Corporate bonds

7.7.1 Characteristics of Commercial Bank Loans

Some of the most important characteristic features of bank loans in India are discussed below:

1. ***Industrialists and Traders Major Receivers of Loans:*** The bulk of the bank loans in India are provided to trade and industries. Banks are less interested in making advances to the agricultural sector because of the relatively greater credit risks related to them and because of the inability of agriculturists to furnish good security.

   However, since nationalisation, banks have shown keen interest in this sector but still industrialists and traders are the major borrowers of the banks.

Notes

2. ***Period:*** Another striking feature of bank loans in our country is that nearly three fourths of them are given for a period of less than one year. Working capital loans are not always for a year or less, but may extend for a period in excess of one year. On the other hand, seasonal loans are taken for a few months.

   Short-term loans may take the form of cash credit and overdraft, demand loans, and the purchase and discounting of bills.

   Some essential features are:

   (a) High liquidity of these loans.

   (b) The short-term loans are given to finance the seasonal needs of businessmen and also for working capital purposes to facilitate the process of production and distribution.

   (c) Seasonal loans are primarily for the purpose of increasing the inventory of a business firm and are repaid as the stock of goods is sold out.

   (d) Short-term funds are borrowed for increasing the current assets and for expanding production. Such loans are repaid out of the net operating earnings of the firm.

   (e) Commercial banks in India demand sound security. A very high percentage of advances (85-90 percent) by Indian banks are secured by goods, financial assets and hypothecation. A major portion of bank credit is given against the security of commodities, which represent short-term security.

   (f) Unsecured credit facilities are given to firms with a sound financial position and stable earning records.

3. ***Loan Documentation:*** Before the bank issues a cheque, customer needs to supply lots of supporting papers. Major loans, such as a mortgage, require more papers and smaller loans lesser papers. Some of the documents are:

   (a) Tax returns for the last three years if self employed.

   (b) Letter of employment.

   (c) Most-recent statements for credit card accounts.

   (d) Documentation of current outstanding home, auto or other loans.

   (e) Letter of assessment.

   (f) Bank account statements for the previous three months.

   (g) Titles for any cars owned.

   (h) Award letter and copy of payment for any legal settlement.

4. ***Bank borrowers generally from the average profitability group:*** Bank borrowers generally fall in the average profitability group. An extremely well running and profitable firm would rely less on bank loans to finance expansion or current needs because it has sufficient earnings and capital of its own.

Bankers should be very careful while granting loans to firms and should take all possible protective steps to minimise their risk of non-recovery.

As a matter of fact, growth is one of the very best reasons for the extension of bank credit. The banker is reluctant to make advances to firms, which have been suffering losses.

Notes

Self Assessment

Fill in the blanks:

17. Commercial banks in India demand …… security.

18. Short-term loans may take the form of cash credit and……., demand loans, and the purchase and discounting of bills.

7.8 Factors Influencing Loan Policy in a Bank

The important factors on which the loan policies of a bank depend are:

- ***Capital Positions:*** The quantum of capital of the bank is certainly the most important factor that influences its loan policy.
  - Capital provides the cushion (base) that absorbs the losses that may occur during course of banking business.
  - Capital serves as a protective factor against losses for depositors and guaranteed funds for the creditors.
  - A bank with a strong capital position can assume more credit risks than one with a week capital position.
  - A bank with high capital can follow a liberal lending policy and provide different types of loans, including long-term loans thus gets higher interest rates.
- ***Profit Targets:*** Profit-making is one of the principal objectives of a commercial bank.
  - Banks may be in a position to emphasize the importance of income, while others may lay stress on liquidity depending on policy, purpose, and managing capability.
  - The banks, which have set income as the principal goal of their lending policies, would follow an aggressive lending policy and might make a larger amount of term loans or customer loans. These loans are normally made at higher interest rates because of the high amount of risk associated in them.
  - Banks should not take greater risks to merely accomplish the objective of profitability.
- ***Deposit Variability:*** Increase and decrease in deposits in the banks also determine their lending capacity.
  - Banks that have experienced unstable deposits in past must follow a conservative lending policy. They cannot afford to incur undue risks by extending their term lending facilities.
  - Banks facing declining deposits should follow a similar policy.
  - Banks whose deposits have shown a rising trend in the past, and which expect the rising trend to persist in future, can also be liberal in their loan policy.
- ***State of Local and National Economy:*** The economic conditions that prevail in the region served by the bank should be kept in mind while formulating the lending policy.
  - A bank operating in an area that is subject to seasonal and cyclical fluctuations cannot afford to adopt a liberal lending policy because that would result into ill-liquidity.

Notes

- In a stable economy, where the possibility of fluctuations in the level of deposits and loan demands is limited, the banker may follow a liberal loan policy.
- Expectation about national economy:
  - If the economic conditions of the country are expected to improve.
  - If the level of business activity is likely to increase.
  - Then banks may liberalize their lending policies and accommodate those borrowers who were previously refused banking facilities because of a stiff credit policy.
  - If the economy is likely to recede (decline) in the future.
  - The banker must revise the existing policy and design a new one with tight terms and conditions of lending, so that only borrowers of a very high credit character are eligible for bank loans and advances.

- ***Monetary Policy:*** The monetary policy of the central banking authorities is a factor in determining the lending policy of a commercial bank.

  The central bank influences the lending policy of banks by bringing about variation in the minimum reserve requirement and the net liquidity ratio.

  If central bank reduces the proportion of the minimum cash reserve, which a commercial bank is required to carry with the central bank, and by reducing the net liquidity ratio, the bank (commercial) will get additional funds to make more advances and vice-versa.

- ***Ability and Experience of Loan Officers:*** The loan officers and staff of the bank play an important role in the execution of its loan policies. Hence, the Board should consider the skill and competence of its loan officers before laying down a loan policy.
  - A bank staffed by a large number of credit officers having expertise, knowledge and rich experience in diverse forms of loans, can afford to provide different types of lending facilities and thus formulate his loan policy accordingly.
  - Mostly big banks have good loan personnel and are able to have a wider and full range loan policy.
  - Smaller banks have to limit their lending business to short-term loans.
  - Small banks normally abstain from consumer lending and term lending to business enterprises because they are ill-equipped with skilled personnel.

- ***Competitive Position:*** A bank enjoying a strong competitive position in the field of term lending must go for it. A weak bank should restrict itself from entering into term loans.

- ***Credit Needs of the Area Served:*** The credit needs of the area served by the bank would also influence its loan policy.
  - If the bank operates in an economy mainly dependent on agriculture, the bank must make its loan policies to meet the seasonal loan demands of the farmers.
  - If the bank operates in an economy mainly dependent on business activities the bank must tailor (make) its loan policies to meet the long and short-term loan demands of the businessmen.
  - A bank is supposed to meet the specific loan demands of all the local borrowers in which it exists for it to succeed.

Notes

Self Assessment

Fill in the blanks:

19. The …….. policy of the central banking authorities is a factor in determining the lending policy of a commercial bank.

20. …….. and …… in deposits in the banks also determine their lending capacity.

Tasks

1. Chart out the procedure for getting loans and advances from bank with the important documents required and other formalities to be completed.
2. Visit the nearest bank and enquire about the prevailing rates of interest on different accounts and loans and advances.
3. Familiarize yourself with the important documents, like application form for loan, including procedure involved in getting Short-term and Term loan.
4. Discuss with Bank Manager/P.R.O. regarding different types of securities to be pledged/mortgaged against any particular type of loan raised.

Case Study

UCO Bank Educational Loan

UCO Bank is a Government of India Undertaken commercial bank. They handle finance operations in various fields, such as, Agriculture, Industry, Trade & Commerce, Service Sector, Infrastructure Sector etc. The bank has a well developed website to provide customers with the option of online banking.

Project Requirements

The bank required a system to process online requests from customers for UCO Education Loan. The bank wanted the visitors (surfers) to be able to submit the education loan application online. The head office users had to have the ability to manage zonal offices, other head office users and state/district details. The zonal office users required the ability to initially approve/reject user applications, assign/reassign approved request to respective branches, update current status of requests and manage branch details of the respective zonal office. The bank also required a daily status generator engine to generate status reports and forward those automatically to the head office and zonal offices every day at a pre-scheduled time.

Solution

The module created by All India Technologies provided the perfect solution to the requirements of the bank. The use of ASP.Net (2.0 framework) with SQL Server in the back end provided ample security and flexibility to the bank in its online operations. The use of separate modules for each operation provided ease of understanding of the system for bank employees.

Contd...

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The Visitor (Surfer) module enabled visitors to submit their loan applications through an online form. On submission, the visitor would receive an acknowledgement mail on his/her specified e-mail id. Later, another mail sent from the bank would inform him/her about the in-principle sanction or rejection of the request.

The Head Office module helped the UCO Bank Head Office users to manage admin users and zonal office details. It enabled them to view online request details and zone wise summary reports. They were also able to perform advanced search and export online request details into a comma-separated-value (CSV) file.

The UCO Zonal Office module helped UCO Bank Zonal Office employees to manage branch, view details of online requests and forward those details to a branch for further processing. They could also reassign and re-forward the online request details to another branch, if necessary. They could update the current status of a request, view branch summary report and also perform advanced search.

A daily status generator engine was provided in the system to generate daily status reports and forward those to the head office and zonal offices at pre-scheduled intervals, without any human intervention.

The modular structure of the project simplified the debugging process, hence providing a bug-free product.

Question

Analyze the case and write down the case facts. Give any other solution to the project requirements of UCO Bank.

Source: http://www.allindia.com/ucobank-casestudy.asp

7.9 Summary

- The second primary function of the commercial banks is to extend loans and advances.
- Lending is the most profitable business of a bank. Banks charge interest from the borrowers, which is more than the interest they pay to their depositors. This results into profit for the bank.
- Commercial banks act as intermediaries between the depositors and the borrowers and make profit out of these transactions.
- Some of the securities against which the banks lend are: commodities, debts, financial instruments, real estate, automobiles, consumer durable goods, documents of title, etc.
- Types of Loans consists of – cash credit, bill discounting, term loans etc. Loans may further be classified as priority sector loans and commercial loans.
- Sometimes, loans are named after the purpose for which they are granted. Almost all the banks in our country give the following loans: personal loan, car loan or auto loan, loan against shares, home loan, education loan or student loan.
- Banks do lending on the basis of cardinal principles viz.: safety, liquidity, diversification of risks, profitability and purpose.
- Banks, while performing lending operations should avoid concentrating the bank's funds in a few customers.
- They should diffuse lending and offer advances to different firms belonging to different industries, which are situated over different geographical areas.

Notes

7.10 Keywords

Advances: Prepayment received for goods or services to be rendered.

Acceptance: A consent given by the person on whom a bill of exchange is drawn, to pay it when due according to the terms of the acceptance.

Car loan or auto loan: A personal loan to purchase an automobile.

Cash credit: A short-term cash loan to a company.

Collateral: It is the additional security given for taking a loan. It is in addition to the prime security given for the loan.

Education loan: The educational loan or student loan is a good banking product for the young and growing Indian masses.

Home loan: A loan taken to purchase or construct a home.

Liquidity/Marketability: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price.

Loan: A loan is a type of debt. Like all other debt instruments, it is to be repaid with interest as per agreed terms.

Loan against shares: A loan, which is secured by the pledge of shares.

Loan syndication: Making arrangement for loans for borrowers. It should not be confused for granting of loans.

Margin money: It is like a security deposit retained by the bank till the loan is fully settled.

Money at call: Money loaned for which repayment can be demanded without notice.

Money at short notice: Money loaned for which repayment can be demanded by giving a short notice.

Mortgage loan: A loan to finance the purchase of real estate, usually with specified payment periods and interest rates.

Overdraft: The word overdraft means the act of overdrawing from a bank account. In other words, the account holder withdraws more money from a bank account than has been deposited in it.

Personal loan/Consumer loan: Consumer loan granted for personal (medical), family (education, vacation), or household (extension, repairs, purchase of air conditioner, computer, refrigerator, etc.) use, as opposed to business or commercial use.

Repayment holiday/Moratorium period: Whenever a loan is taken especially for acquiring fixed assets, the repayment does not start immediately.

Secured loan: A secured loan is a loan in which the borrower pledges some asset (e.g., a car or property) as collateral for the loan, which then becomes a secured debt owed (payable) to the creditor who gives the loan.

7.11 Review Questions

1. Discuss various types of loans granted by commercial banks.
2. Describe the characteristics of commercial bank loans.
3. Explain the cardinal principles of sound bank lending.

Notes

4. What are the factors influencing loan policy?
5. Explain the manner of organisation of bank lending.
6. What are outright loans?
7. What is cash credit means?
8. What is meant by O/D facility?
9. Make differences between the cash credit account and overdraft.
10. Discuss the nature of loans granted by commercial banks.
11. What is additional security?
12. Differentiate between secured and unsecured loans.
13. Describe the management of loans in commercial banks.
14. What is primary sector lending?
15. What is discounting of bills of exchange?

Answers: Self Assessment

1.	Fixed	2.	Opposite
3.	Overdraft	4.	After
5.	Do not	6.	Concessional
7.	Commercial	8.	Liberalized
9.	Personal	10.	Aggressive
11.	Liabilities	12.	Differs
13.	Free	14.	Credit worthiness/Paying capacity
15.	Operations	16.	Real Estate
17.	Sound	18.	Overdraft
19.	Monetary	20.	Increase; decrease

7.12 Further Readings

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Notes

Unit 8: Banking Systems

CONTENTS

Objectives

Introduction

8.1 Corporate Banking

8.2 Retail Banking

8.2.1 Retail Banking – Retail Lending Schemes (Asset Focused Segment)

8.2.2 Retail Banking – Liability Focused Segment (Deposit Accounts)

8.3 Merchant Banking

8.3.1 Significance of Merchant Banking

8.3.2 Functions of Merchant Banking

8.4 Treasury Management

8.4.1 Objectives of Treasury Management

8.4.2 Functions of Treasury Management

8.5 Summary

8.6 Keywords

8.7 Review Questions

8.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Define Corporate Banking
- Classify Corporate Bank Customers
- Elaborate on Retail Banking
- Discuss significance and functions of Merchant Banking
- Describe Treasury Management

Introduction

Previous unit gave you an insight on loans and advances provided by banks whereas in this unit you will study about different banking systems such as corporate banking, retail banking, merchant banking and treasury management. Banking system can be defined as the structural network of institutions that render financial services within a nation. The members of the banking system and the functions they typically execute comprises of commercial banks that take deposits and make loans, investment banks which specialize in capital market issues and trading, and national central banks that issue currency and set monetary policy. Banking System is a chief mechanism through which the money supply of the country is ensured and controlled. The banking system enables us to understand Commercial Banks, Secondary Banks, Central

Notes

Banks, Merchant Bank or Accepting Houses and Discount Houses but except saving banks and investment banks and other intermediaries.

8.1 Corporate Banking

Corporate banking includes products and services that are offered specially to corporations such as lending services that could be in the form of a secured or unsecured loan, financing, underwriting, cash management, issuing of stocks and bonds etc. Few of these transactions may include various banks and syndicates.

Corporate banking represents a wide range of banking and financial services provided to domestic and international operations of large local corporates and local operations of multinational corporations.

Services of corporate banking include the following:

- Access to commercial banking products, including working capital facilities such as domestic and international trade operations and funding,
- Channel financing, and overdrafts,
- Letters of guarantee, etc.
- Structured solutions both onshore and offshore,
- Term loans (including external commercial borrowings in foreign currency),
- Domestic and international payments,
- Support to client's worldwide operations, ensuring a full understanding of the company's business and financial needs.

Banks may classify their corporate customers into three segments on the basis of capital employed and sales volume: Large corporations, Mid-size companies, and Small and Medium business Enterprises (SMEs). Corporate customers can be further segmented into industry verticals, such as automobiles, aviation, tourism, etc. Banks develop long-term relationships with their corporate clients as a part of their marketing efforts. In a competitive market, building strong relationships with the customers help to retain customers and improve profitability. The communications and relationships between the banks and their corporate clients are affected by three factor groups – the external environment, the atmosphere of the interactions, and the interaction process. The 'Partnership Relationship Lifecycle Model' describes the evolution of the bank-corporate customer relationship, beginning at an early stage where a 'customer' shows interest in the bank's offerings, and growing to become a mutually beneficial 'partnership relationship' between the 'client' and the bank.

Did u know? Banking products are broadly classified into fund-based products and fee-based services.

Fund-based products are further subdivided into asset products and liability products.

- Liability products include salary accounts, current accounts, fixed deposits, and payment cards.
- Asset products include various kinds of credit products like trade finance, corporate finance, project finance, and term loans.

Notes

Fee-based services can be further classified into corporate and retail fee-based services.

- Organizations avail of such services for meeting both their short-term and long-term financial requirements. The common fee-based services offered to corporate clients are: cash management services, letter of credit, bank guarantees, bill discounting, factoring/ forfeiting, forex services, merchant banking, registrar services, underwriting services, custodial services, lease and hire purchase, and credit rating.
- Retail fee-based services are availed of at large by the retail customers for payments, money transfers, personal wealth management, online trading, etc.

Banks need to deal with the changing requirements of their customers through new product development. However, financial products can be easily replicated.

The pricing of banking products directly affects customer acquisition and customer retention, in addition to profitability and long-run viability.

Caution Price is a mechanism to cover the costs of operations which comprises of production costs, distribution costs, promotion costs, and other operational expenses.

The pricing decision is influenced by many factors such as cost, competition, customers, and other constraints. With the advent of deregulation and the simultaneous rise in competition, many of the banks have acquired a competitive pricing strategy. RBI has deregulated the pricing mechanism for both asset and liability products. Every bank has to set its own Benchmark Prime Lending Rate (BPLR) to price its asset products. A bank may price its asset products (for a given customer either above or below the BPLR, depending on situational factors such as credit-worthiness of the customer, stage of relationship, etc.

Notes New product development and innovation are considered essential for a bank's long term sustainability.

Corporate banking products are distributed mainly through a direct sales force or bank branches, supplemented by phone banking and online banking. Relationship officers are based at several branches of banks; they make frequent client visits to nurture relationships and to develop fresh business opportunities. Banks attempt to develop an optimal distribution mix using personal/ non-personal ways of delivery, in order to achieve various objectives such as superior customer service, operational efficiency, and profitability. Integrated banking software applications – usually referred to as Core Banking Solutions (CBS) — are essential to the real-time synchronization of the transactions that happen through the different modes of distribution.

The small and medium business enterprises (SME) sector is regarded as the growth engine of the Indian economy; it generates employment for nearly 30 million people and contributes around 30 percent to the nation's GDP. However, corporate bankers ignored this segment for a long run due to the high incidence of Non-performing Assets (NPA) and the lack of proper tools to assess the credit rating of the SMEs. This trend is changing and the SME segment is now one of the focus areas of growth for several banks. This shift has been affected by the policy initiatives introduced by the Reserve Bank of India and the government in favour of SMEs. With big enterprises getting access to cheaper funds from other channels, their bargaining power has been increased with respect to the banks. This situation has also induced corporate bankers to look at SMEs as an avenue for profitable growth.

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Caselet

Corporate Banking Business of ICICI Bank

ICICI Bank provides innovative financial solutions to its corporate clients, tailored to meet their requirements, while diversifying its revenue streams and generating adequate return on risk capital through risk-based pricing models and proactive portfolio management. Its focus in the financial year 2003 is on technology-driven enhancement of delivery capabilities to offer improved service levels to clients. It set up centralized processing facilities for back office operations where technology is leveraged to benefit from economies of scale arising out of large transaction volumes. During the year it continued to expand the scope of its Web-based services. ICICI Bank provides corporate internet banking services through ICICIebusiness.com, a single point web-based interface for all corporate products. The portal enables clients to conduct their banking business with ICICI Bank through the Internet in a secure environment.

ICICI Bank offers online foreign exchange and debt securities trading services. A dedicated product and technology group develops and manages back-office processing and delivery systems. Dedicated relationship groups for corporate clients and the government sector focuses on expanding the range and depth of its relationships in these sectors. In the corporate segment, it focuses on leveraging its relationships to expand the range of products and services to channel finance, transaction banking and non-fund based products.

ICICI Bank has strong relationships with several large public sector companies and state governments and it is leveraging these relationships to expand the range of transaction banking services. It has already been empanelled for collection of sales tax in eight states. It continued to focus on corporate lending transactions including working capital finance to highly rated corporate, structured transactions and channel financing. It also focused on leveraging its skills in originating and structuring transactions as well as on its ability to take large exposures to adopt an originate-and-sell-down strategy.

This not only increased the risk-adjusted return on the capital employed but also enabled it to offer a comprehensive solution to its corporate clients. ICICI Bank's dedicated structured finance, credit and markets group, with expertise in financial structuring and related legal, accounting and tax issues, actively supports the business groups in designing financial products and solutions. This group is also responsible for managing the asset portfolio by structuring portfolio buy outs and sell-downs with a view to increase the risk-adjusted return on the capital. During fiscal 2003, ICICI Bank focused on the agri-financing segment and developed several innovative structures for agri-business, including dairy farming, farmer financing and warehouse-receipt-based financing.

It achieved robust growth in this segment and is working with state governments and agri-based corporate to evolve viable and sustainable systems for financing agriculture. It has also integrated its rural banking, micro-finance and agri-financing activity to offer integrated banking services in rural areas.

Source: www.icicibank.com/

The Global Relationship Management teams of the banks are tasked with understanding in depth the sectors in which clients operate with the aim of adding value through detailed industry knowledge and structured financial solutions.

Sector-based Client Service teams that combine relationship managers, product specialists and industry specialists to develop customized financial solutions service clients are engaged.

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In today's global banking scene, Corporate Bankers are facing a series of unprecedented and sweeping challenges in the areas like Treasury Management, Trade Finance, Risk Management, Compliance Management, Electronic Trading and Derivatives Markets. Adding to this are the mounting complexities from ongoing regulatory changes, decreasing margins and fierce competition.

Self Assessment

State whether the following statements are true or false:

1. Banks develop short-term relationships with their corporate clients as a part of their marketing efforts.
2. The pricing decision is not influenced by such factors such as cost, competition, customers, and other constraints.
3. Every bank has to set its own Benchmark Prime Lending Rate (BPLR) to price its asset products.
4. The pricing of banking products directly affects customer acquisition and customer retention.

Fill in the blanks:

5. Cash inflows and outflows are checked by …… manager.
6. It is the function of treasury management to minimize the …….. .
7. The main function of treasury management is to maintain the …….. of business.

8.2 Retail Banking

The relationship between the bankers and the customers is not the same like before. The market has undergone a sea change. The customers have become more demanding today. The transition from sellers market to buyers market has compelled the bankers to understand the pulse and needs of the customers.

It may not be incorrect to say that the banking products and services today are designed by the customers. The luxury of discretion to design the products and services by the bankers is not any more available to the bankers.

Bankers today have no choice except to alter their product mix, delivery channels and corporate structure to serve their functional role. Some of the products which were shunned by the bankers and were treated as inflationary 20 years ago in nature like housing loan, consumer durables finance which otherwise were the prerogative of the bank employees have become targets of bank business and area of fierce competition and business mantra. Banks are vying with each other to sell across their ideas and products in the compelling hours of competition and the unexpected quarters say cooperative banks too have joined the fray.

Retail banking has wider connotation and is not the same as that of retail lending. Retail banking refers to the efforts of the bankers to reach up to the customers on both fronts of the balance sheet i.e., Liabilities side as well as Assets side. Under the liabilities side, we have deposits. Unless the banker designs the products according to the needs of the customers and facilitate better bargain to them in terms of rate interest, time and delivery channels, it is not easy for them to solicit business in this segment. The age of walk in deposits is gone. With interest deregulation in the sector of deposits with the sole exception of Savings Bank Account, where the apex monetary authority continues to decide the rate of interest, rest of the fields are open for competition.

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In the Assets side, we have credit/loan schemes of the various banks. The job of the banker has become very difficult in this segment too. Bankers today are offering various sops to attract the potential customers. For instance, payment of free insurance premium by the bank comes along with the vehicle loan in respect of few banks. Some banks are prepared to offer total credit solutions along with housing loan, we mean here, they have enabled facility of consumer durables finance, vehicle finance in one go the customers who avail of housing loan from them.

This way, we understand retail banking includes designing delivery of customized products from both sides of the balance sheet.

The following channels are effectively utilized by the bankers to mobilize business from the potential clients:

- Premises banking or banking at doorsteps
- Automated Teller Machines
- Debit Cards and Credit Cards
- Telephone banking
- Internet Banking
- Mobile Banking
- Electronic Funds Transfer/Electronic Clearing System debit

8.2.1 Retail Banking – Retail Lending Schemes (Asset Focused Segment)

There has been a great heat of competition in selling ideas, products and services under this segment between one bank and the other. Retail lending, a departure from conventional advance, offers higher yield, quicker turn, the possibility of less incidence of the account going bad or non-performing if it is monitored on an ongoing basis. Monitoring of the account is easier in retail lending segment as compared to the conventional advances, for the reason that installments and repayment schedule have to be monitored in respect of retail lending.

Example: An advance to an industrial unit, security verification, conduct of the account by the borrower, compliances with statutory norms by the unit, submission of periodical returns like balance sheet, income tax assessment order and other regulatory ones from time to time.

While novel retail lending products are introduced by the banks to compete effectively in the market, the products which are prevalent in the industry and marketed by the banks are given below, as an illustration:

- Housing Finance.
- Consumer durable finance.
- Vehicle (two-wheelers and four-wheelers) finance
- Personal Loan
- Advance against future lease rentals
- Mortgage Loan
- Pension Loan etc.

Margin: The contribution brought in by the borrower is termed as margin. Margin requirements differ from one type of finance to others and they differ from one bank to the other. There is no standard capsule of margin in this segment.

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Interest: The rate of interest has been deregulated by the apex monetary authority which suggests that the rate of interest offered by one bank for a retail lending scheme may not match with the one offered by the other bank. The rate of interest is decided by the individual banks.

Figure 8.1: Composition of Retail Lending (RBI report on Trend & Progress of Banks 2002-03)

1	Housing	₹ 34654 Crores	50%
2	Consumer durables	₹ 6904 Crores	10%
3	Loans to Individuals agt Shares etc.	₹ 1762 Crores	5%
4	Other Priority Sector/ Personal Loans	₹ 26089 Crores	35%
5	TOTAL	₹ 69409 Crores	100%

Source: Iyengar, G. Vijayaragavan, "*Introduction To Banking*" 2011, (P-307), Excel Books Pvt. Ltd.

8.2.2 Retail Banking – Liability Focused Segment (Deposit Accounts)

Saving Fund Account/Savings Bank Account

A saving fund account may be opened by a properly introduced individual singly or jointly, minors of the age of 10 years and above and minors under natural/legal guardianship.

Saving fund account cannot be opened in the name of any business concern whether proprietary/ company/partnership or association. Savings fund account cannot be opened in the name of:

- Panchayat Samitis
- Government departments
- State housing boards
- Water/Sewerage and Drainage Boards
- Housing Corporations/societies
- State Text Book Publishing Corporations
- Municipal corporations
- Industrial Development Authorities
- State Electricity Boards
- State Text Book Publishing Corporations
- Metropolitan Development Authority
- Any bank including land development banks

The following are the exceptions to the above. Saving Fund account can be opened in the name of the following:

- Any Government dept./body/agency in respect of grants/subsidies released for implementation of schemes sponsored by Central Government subject to production of an authorization from respective Govt. departments to open savings fund account, e.g., District Rural Development Agency, Member of Parliament Local Area Development Scheme, Khadi and Village Industries Board, Agriculture Produce Market Committee.
- Companies licensed under Section 25 of Companies Act, 1956, which are permitted not to add to their names the word "limited ", e.g., Indian Banks Association.

Notes

- Societies Registered under Societies Registration Act 1860 or any other corresponding law
- Primary cooperative credit society being financed by the bank
- Any trust/institution whose entire income is exempted from payment of income tax
- Any other institution permitted by RBI on application made by the bank
- SF account in the name of Hindu Undivided Family (HUF) can be opened if it is not engaged in business activity
- Farmers Club
- Development of children and women in rural areas
- Self Help Groups
- Banks can also open SF account of state Govt. dept./bodies/agencies in respect of grants/ subsidies released for implementation of various State Government plans subject to obtaining an authorization that the department is authorized to open Savings Fund Account from the department itself.

Self Assessment

State whether the following statements are true or false:

8. Monitoring of the account is not easier in retail lending segment as compared to the conventional advances.
9. Margin requirements differ from one type of finance to others and further from one bank to the other.
10. Retail Banking has narrower connotation and is not the same as that of retail lending.
11. Bankers today have no choice except to alter their product mix, delivery channels and corporate structure to serve their functional role.

8.3 Merchant Banking

Merchant Banking is a combination of banking and consultancy services that banks provide to its customers. It renders consultancy, to its clients, for various matters such as financial, marketing, managerial and legal. Consultancy refers to provide advice, guidance and service for a fee. It helps a businessman in commencing a business. It helps to raise (collect) finance. It helps to modernize, expand and restructuring of the business. It helps to revive sick business units. It also helps companies to register, buy and sell shares at the stock exchange. In short, merchant banking provides a wide range of services for beginning, until running a business. It acts as Financial Engineer for a business.

"Merchant banking refers to a form of banking that both commercial and investment banks participate in. It involves trading unregistered securities including stock, bonds and private equity securities. Merchant banking serves large businesses, including international corporations, and some wealthy individuals. However, its role in the economy can affect consumers at all levels."

8.3.1 Significance of Merchant Banking

The very existence of merchant banking shows the need for specialized investment information. This is the main role of merchant banking. While many commercial banks may be satisfied with

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standard business plans and market research, the merchant bank is an active player in the field itself. The seasoned merchant banker knows exactly where strategic assets are situated, and which firms and strategies to fend off. With a merchant banker, a small business person is hiring a skilled partner with a long-term interest in the field. The real significance here is that using a merchant bank lowers the risks for a new firm.

8.3.2 Functions of Merchant Banking

Merchant banking is a service oriented industry. Merchant banks all over the world carry out the same set of services. In India, merchant banks carry out the following functions and services, specifically:

1. Corporate Counselling
2. Project Counselling
3. Pre-investment Studies
4. Capital Restructuring
5. Credit Syndication
6. Issue Management and Underwriting
7. Portfolio Management
8. Working Capital Finance
9. Acceptance Credit and Bill discounting
10. Mergers, Amalgamations and Takeovers
11. Venture Capital
12. Lease Financing
13. Foreign Currency Finance
14. Fixed Deposit Broking
15. Mutual Funds
16. Relief to Sick Industries
17. Project Appraisal

Each of these functions is detailed briefly below:

Corporate Counselling

Corporate counselling is the set of activities that is undertaken to ensure the efficient running of a corporate enterprise. It may include the rejuvenating of old line companies and ailing units, and directing the existing units in identifying the areas or activities for growth and diversification. The merchant banker directs the clients on various aspects like location factors, organizational size, operational scale, choice of product, market survey, cost analysis, cost reduction, allocation of resources, investment decision, capital management and expenditure control, pricing, etc.

Following are the activities which form part of corporate counselling:

1. Providing guidance in areas of diversification based on the Government's licensing and economic policies.

Notes

2. Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.
3. Rejuvenating old-line companies and ailing and sick units by appraising their technology and process assessing their requirements and restructuring their capital structure.
4. Commissioning of diagnostic studies.
5. Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.
6. Arranging for the approval of the financial institutions/banks for schemes of rehabilitation involves financial relief, etc.
7. Providing assistance in getting soft loans from financial institutions for capital expenditure, and the requisite credit facilities from the bank.
8. Monitoring of rehabilitation schemes.
9. Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

Task Visit and organization which had recently had counselling and study various activities and methods of corporate counselling done by the concerned bank.

Project Counselling

Project counselling is a part of corporate counselling. It includes the study and analysis of the viability of a project and the steps required for its efficient and effective implementation are broadly the subject matter of project counselling.

Following are the activities that form a part of the project counselling:

1. Undertaking the general review of the project ideas/project profile.
2. Providing advice on procedural aspects of project implementation.
3. Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.
4. Assisting in the selection of a Technical Consultancy Organization (TCO) for preparing project reports and market surveys, or review of the project report or market survey reports prepared by TCO.
5. Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consents for implementation of the project.
6. Assisting in obtaining approvals/licenses/permissions/grants, etc. from government agencies in the form of letter of intent, industrial license, DGTD registration, and government approval for foreign collaboration.
7. Providing guidance to Indian entrepreneurs for making investment in Indian project in India and in Indian joint ventures overseas.
8. Identification of potential investment avenues.

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9. Carrying out precise capital structuring and shaping the pattern of financing.
10. Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.

Pre-investment Studies

Pre-investment studies relate to the activities that are concerned with making a detailed feasibility exploration to evaluate alternative avenues of capital investment in terms of growth and profit prospects. Some of these activities are as follows:

1. Carrying out an in-depth investigation of environment and regulator factors, location of raw material supplies, demand projections and financial requirements in order to assess the financial and economic viability of a given project.
2. Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to accentuate corporate profitability and growth in the long run.

Capital Restructuring Services

Merchant bankers assist the corporate enterprises in structuring their capital in such a way that it would minimize the cost of capital and maximize its return on capital invested.

Following are the services that are covered in capital restructuring:

1. Examining the capital structure of the client company to determine the extent of capitalization required.
2. Preparing a comprehensive memorandum for the controller of Capital issues, and securing consent where the capitalization takes place through issue of bonus shares.
3. Suggesting an alternative capital structure conforming to legal requirements, viz., extent of capitalization on reserve and quantum of disinvestments by 'offer for sale' and/or fresh issues of corporate securities such as equity share, and preference share in the case of FERA/FEMA companies.
4. Preparing a memorandum covering valuation of shares and justifying the level of premium applied for.

Credit Syndication

Activities connected with credit procurement and project financing, aimed at raising Indian and foreign currency loans from banks and financial institutions are collectively known as 'credit syndication'.

Activities that are covered under credit syndication are as follows:

1. Estimating the total cost of the project to be undertaken.
2. Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.
3. Preparing loan application for financial assistance from term lenders/financial institutions/ banks, and monitoring their progress, including pre-sanction negotiations.
4. Selecting institutions and banks for participation for financing.

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Credit syndication services overlap with the activities of project finance and project counselling. But the loan syndication also includes the preparation of applications for financial assistance from financial institutions/banks.

Issue Management and Underwriting

Issue management and underwriting refers to the activities relating to the management of the public issues of corporate securities, viz. equity shares, preference shares, and debentures of bonds, and are aimed at mobilization of money from the capital market.

Following are some of the popular services provided by merchant bankers in this regard:

1. Preparation of an action plant.
2. Preparation of CCI application and assisting in obtaining consent/acknowledgement.
3. Preparation of budget for the local expenses for the issues.
4. Selection of issues Houses and advertising agencies for undertaking pre and post-issue publicity.
5. Obtaining the approval of institutional underwriters and stock exchanges for publication of the prospectus.
6. Drafting of prospectus
7. Selection of institutional and broker underwriters for syndicating/underwriting arrangements.

Portfolio Management

Portfolio management can be defined as making decisions for the investment of cash resources of a corporate enterprise in marketable securities by deciding the quantum, timing and the type of security to be bought.

The services covered are as follows:

1. Undertaking investment in securities.
2. Undertaking review of Provident fund investment, Trust investment, etc.
3. Undertaking investment for non-resident Indians, on both repatriation and non-repatriation basis.
4. Collecting and remitting interest and dividend on investment.
5. Carrying out a critical evaluation of investment portfolio.
6. Safe custody of securities in India and overseas.
7. Providing advice on selection of investments.

Working Capital Finance

The finance required for meeting the day-to-day expenses of an enterprise is known as 'Working Capital finance'.

1. Assessment of working capital requirements.
2. Preparing the necessary application to negotiations for the sanction of appropriate credit facilities.

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3. Advising on the issue of debentures for augmenting long-term requirements of working capital.
4. Assisting, coordinating and expediting documentation and other formalities for disbursement.

Acceptance Credit and Bill Discounting

Acceptance credit and bill discounting connotes the activities relating to the acceptance and the discounting of bills of exchange, besides the advancement of loans to business concerns on the strength of such instruments, are collectively known as 'Acceptance Credit and Bill of discounting.

In order to the bill accepting and discounting takes place on sound lines, it is imperative that the firm involved commands a good reputation and financial standing.

Merger and Acquisition

This is a specialized service provided by the merchant banker who arranges for negotiating acquisitions and mergers by offering expert valuation regarding the quantum and the nature of considerations, and other related matters.

The various functions that form part of this activity are as follows:

1. Identifying organizations with matching characteristics.
2. Undertaking management audit to identify areas of corporate strength and weakness in order to help formulate guidelines and directions for future growth.
3. Obtaining approvals from shareholders, depositors, creditors, government, and other authorities.
4. Conducting exploratory studies on a global basis to locate overseas markets, foreign collaborations and prospective joint venture associates.
5. Monitoring the implementation of merger and amalgamation schemes.

Merchant bankers provide advice on acquisition propositions after careful examination of all aspects, viz, financial statements, articles of associations, provisions of companies act, rules and guidance of trade chambers, the issuing house associations, etc.

There are many reasons for the recent trend towards mergers and amalgamations, such as:

1. Existence of excess unused manufacturing capacity of the purchasing company, which can be utilized efficiently by taking over other units.
2. Lack of manufacturing space with the purchase company. The best solution may be to buy the controlling interest in another company having excessive manufacturing space or capacity.

Venture Financing

Venture capital is the equity financing for high-risk and high-reward projects. The concept of venture capital originated in the USA in the 1950s, when business magnates like Rockefeller financed new technology companies. The concept became more popular during the sixties and seventies, when several private enterprises undertook the financing of high-risk and high reward projects.

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Lease Financing

Leasing is an important alternative source of financing a capital outlay. It involves letting out assets on lease for use by the lessee for a particular period of time.

Following are the important services provided in regard to leasing:

1. Providing advice on the viability of leasing as an alternative source for financing capital investment projects.
2. Providing advice on the choice of a favourable rental structure.

In India, leasing is a non-banking financial activity. Commercial banks like State Bank of India and Canara Bank also provide lease financing by forming subsidiaries under the amended Banking Regulations Act of 1949.

Foreign Currency Financing

Foreign currency finance is the fund provided for foreign trade transactions. It may take the form of export-import trade finance, euro currency loans, Indian joint venture abroad or foreign collaborations. The main areas that are covered in this type of merchant activity are as follows:

1. Providing assistance for carrying out the study of turnkey and construction contract projects.
2. Providing guidance on forward cover for exchange risk.
3. Providing assistance in opening and operating banks accounts abroad.
4. Providing assistance in applications to working groups, liaison with RBI, ECGD and other institutions.
5. Providing assistance in obtaining export credit facilities from the EXIM bank for export of capital goods, and arranging for the necessary government approvals and clearance.
6. Assisting in arranging foreign currency guarantees and performance bonds for exporters.

Forms of Foreign Currency Loans

The various types of foreign currency loans are:

- Euro-currency Loans
- Financing Indian Joint Ventures abroad through:
  - Advice on the nature of client's investment.
  - Financial structuring of the project
  - Syndication of Euro loans
  - Bank guarantees
  - Procuring euro-currency facilities in the form of management and syndication of Euro-currency loans, bonds, Floating Rate Notes (FRNs), Floating Rate Certificates of Deposits (FRCDs), US commercial papers, with the assistance of International Treasury Management Limited (ITM).
  - Providing advice on currency swaps and interest rate swaps.
  - Arranging deferred term export finance to Indian entrepreneurs by maintaining a quick liaison with the export country's Export Credit Agencies who offer fixed rate

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finance at concessionary interest rates, in particular export credit agencies in the UK (ECGD), USA (EXIM Bank), Japan, Italy, Norway, East Germany (HERMES), and who enjoy lines of credit from France (COFACE), Korea, Spain, Austria, Canada, Denmark, and India.

- Providing assistance in foreign collaborations through:
  - Helping locate foreign collaboration and joint venture partners abroad.
  - Providing advice on local laws, product risk, government regulations regarding shareholdings, exchange restrictions, taxation, dividends, incentives and subsidies, etc.

Brokering Fixed Deposits

Following are the services rendered by merchant bankers in this regard:

1. Computation of the amount that could be raised by a company in the form of deposits from the public and loans from shareholders.
2. Helping the company of observe all the rules and regulation in the connection.
3. Making arrangement for payment of interest amounts.
4. Drafting of advertisement for inviting deposits.
5. Filing a copy of advertisement with the Registrar of Companies for registration.
6. Providing advice to the company on the terms and conditions of fixed deposits, and deciding on the appropriate rate of interest, keeping in view the prevailing capital and money market conditions.

Mutual Funds

Mutual funds are institutions that mobilize the savings of innumerable investors for the purpose of channelling them into productive investments in a wide variety of corporate and other securities.

Some of the services rendered by mutual funds are as follows:

1. Mopping up public savings.
2. Investing the funds in a diversified portfolio of shares and debentures belonging to well managed and growing companies.
3. Earning investors a steady return on investments with an assurance of capital appreciation.

Relief to Sick Industries

Merchant bankers extend the following services as part of providing relief to sick industries:

1. Rejuvenating old-lines and ailing units by appraising their technology and process, assessing their requirements and restructuring their capital base.
2. Evolving rehabilitation packages which are acceptable to financial institutions and banks.
3. Exploring the possibilities of mergers/amalgamations, wherever called for.

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Project Appraisal

The evaluation of industrial projects in terms of alternative variants in technology, raw materials, production capacity and location of plant is known as 'Project Appraisal'.

Financial Appraisal

Financial appraisal involves assessing the feasibility of a new proposal for setting up a new project or the expansion of existing production facilities. Financial appraisal is undertaken through an analysis which takes into account the financial features of a project, including sources of finance. Financial analysis helps to trace the smooth operation of the project over its entire life cycle.

Technical Appraisal

Technical appraisal is primarily concerned with the project concept in terms of technology, design, scope and content of the plant, as well as inputs are infrastructure facilities envisaged for the project. Basically, the project should be able to deliver a marketable product from the resources deployed, at a cost which would leave a margin that would be adequate to service the investment, and also plough back a reasonable amount into the project to enable the enterprise to consolidate its positions.

Economic Appraisal

Economic appraisal of a project deals with the impact of the project on economic aggregates. These may be classified under two broad categories. The first deals with the effect of the project on employment and foreign exchange, and the second deals with the impact of the project on net social benefits or welfare.

Self Assessment

Fill in the blanks:

12. Venture capital is the ……. financing for high-risk and high-reward projects.
13. Foreign currency finance is the fund provided for …….. trade transactions.

8.4 Treasury Management

Treasury management can be described as the management of cash, funds, currency, bank and financial risk. That's why it is an imperative tool of finance. Cash inflows and outflows are checked by finance manager. The finance manager makes the list of all receivable amounts which will increase the treasure house of the company. He also keeps a track record of the dates in which he has to receive the fund from debtors. Under this management, he estimates all financial risk for the investment of cash. All investment is done on the basis of investment policy. Many organizations have separate treasury department. If company deals with foreign currency, then management of foreign currency risk is the duty of treasury department. Suppose, Google Inc. USA Company which is a MNC and it receives the fund from advertisers and shares with ad-sense publisher. A good treasury officer can give the advice to Google Inc. about when company should pay the bill of ad-sense publishers.

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Example: There are 90, 00,000 ad-sense publishers and approximate US $100 which company has to pay to each Indian ad-sense publisher after one month. Now within 15 days, Google Inc. will choose that day when the price of dollar in Rupees will be minimum. Suppose, if company paid on 21st Feb. 2010 US $100 to one publisher when the price of dollar is ₹ 46.5 and pays ₹ 2139 and if the next day, price will decrease 0.5 dollar. Then, it means Google Inc. is in foreign currency loss ₹ 50 each publisher because, company has power to pay in next day and save ₹ 50 for each ad-sense publisher. If company has to pay US $100, then company can receive loss of ₹ 45 Crore due to foreign currency loss.

So, to manage and control foreign currency is the major project under treasury management. In government departments, fund management is under treasury management. Treasury department makes map to collect for govt. treasure and decide how to use it for welfare works. Finance manager creates good relationship for getting locker facility at cheap rates and company can keep its important documents in locker of banks. These documents and commercial papers can be sold by banks in money market and company can take part in money market by indirect way.

Notes Finance manager also do the duty to sell company's fixed assets at high price and he also acquire the properties for company at cheap rate for effective utilization of treasure of company.

8.4.1 Objectives of Treasury Management

Treasury management is done with the following objectives:

Risk Management Objectives

Following are the risk management objectives of treasury management:

- To ensure the stability of the boroughs financial position, by sound risk-management techniques;
- To constantly address the need to minimize risk and volatility whilst aiming
- To achieve the treasury management strategic objectives.

Borrowing Objectives

Following are the borrowing objectives of treasury management:

- To ensure that exposure to different types of borrowing instruments is at a prudent level relative to the Council's outstanding debt.
- To achieve the lowest level of interest paid on the Borough's debt as prudently possible while at the same time minimizing the potential volatility of the average rate of interest.
- To achieve an average rate of interest that falls within the best performing quarter of London Boroughs.
- To effect funding in any one year at optimum cost - having regard to future risks from movement in interest rates or variable rate borrowing.

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- To manage the debt maturity profile, ensuring that in any one year repayments are no greater than 15% of the long term debt outstanding, with a restriction on 50% of debt maturing over the first five years of the portfolio.
- To ensure that the average maturity period of long-term loans outstanding is greater than 7 years.
- To take advantage of debt restructuring and debt repayment opportunities that may arise, for future revenue savings - taking into account the risks involved.

Investment Objectives

Following are the investment objectives of treasury management:

- To achieve an overall return on total deposits of at least one quarter of one per cent above the average seven day notice London Interbank Bid Rate (LIBID) - the rate at which a bank will bid to borrow money in the London money market with the minimum risk of capital loss.
- To achieve an average rate of interest that falls within the best performing quarter of the London Boroughs.

8.4.2 Functions of Treasury Management

The main functions of treasury management are as follows:

To Maintain the Liquidity of Business

The main function of treasury management is to maintain the liquidity of business. Without proper liquidity, it is very risky for business to operate smoothly. By using cash flow analysis and working capital management, treasury officer makes a good ratio of liquid assets and liquid liability.

To Minimize Currency Risk

In above example of Google Inc. business, it is already explained that it is the function of treasury management to minimize the currency risk. For this, treasury managers remain in touch with currency market of the world. They analyze the reason of crisis in currency market. Sometimes this crisis will be benefited for them because they have to pay less to other country for getting their service at cheap rates.

To Provide Quick Finance to Company

It is also function of treasury department to supply quick finance to company, when it needs the money. For this, a good network in financial market is required.

Self Assessment

Fill in the blanks:

14. A finance manager keeps a track record of the …….. in which he has to receive the fund from debtors.
15. Finance manager creates a good relationship for getting locker facility at cheap rates and company can keep its important …….. in locker of banks.

Notes

Case Study

Retail Banking Business of ICICI Bank

Mr. Bhargava Dasgupta heads the international business operations of ICICI bank and he has to travel a lot these days. He is busy in building the ICICI bank's next big platform-globalization. He feels that it is impossible to reach to the clients everywhere across the world physically for providing the financial services, so it will be strategically sound to leverage the relationships with other banks in serving the global consumer. The success of the bank in the domestic market is largely credited to the customer orientation, high quality of customer service, innovative financial product introductions and active involvement in serving the emerging and latent needs of the Indian consumer. They want to take their domestic market success to the global level. The recent spot of operations by the bank is an indicator of becoming a global financial service provider. ICICI bank has opened its first overseas branch in Singapore in 2003; in mid 2003, they opened the representative offices in London. They are close to acquire properties by the year 2003 end in Pundong and have already procured properties in East London to start their business operations including strategies to open offices in Toronto and Bahrain.

Retail banking is a key element of ICICI's growth strategy. With upward migration of household income levels, increasing affordability of retail finance and acceptance of use of credit to finance purchases, retail credit has emerged as a rapidly growing opportunity for banks that have the necessary skills and infrastructure to succeed in this business. ICICI Bank has capitalized on the growing retail opportunity in India and has emerged as a market leader in retail credit. The dimensions of the retail strategy include innovative products, parity pricing, customer convenience, strong processes and customer focus.

Cross-selling of the entire range of credit and investment products and banking services to customers is a critical aspect of ICICI's retail strategy. ICICI Bank offers a wide range of retail credit products. It has expanded the market significantly over the last few years by taking organized retail credit to a large number of high-potential markets in India, by penetrating deeper into existing markets and by offering customized solutions to meet the varying credit needs of the Indian consumer.

ICICI Bank is one of the leading providers of mortgage loans, two-wheeler loans, commercial vehicle loans and personal unsecured loans, and continues to maintain leadership in automobile finance. ICICI Bank's total retail disbursements in fiscal 2003 are approximately ₹ 200 billion. Retail credit constituted 18% of ICICI Bank's balance sheet at March 31, 2003, compared to only 6% at March 31, 2002. Cross selling has emerged as one of the significant drivers of retail credit growth. In fiscal 2003, cross selling accounted for about 20% of mortgage loans and auto loans and about 25% of credit cards issued. In May 2003, ICICI Bank acquired the entire paid-up capital of Transamerica Apple Distribution Finance Private Limited (TADFL), which is renamed as ICICI Distribution Finance Private Limited (IDFL). IDFL is primarily engaged in providing distribution financing in the two-wheeler segment. The acquisition is expected to supplement the Bank's retail franchise, especially in the two-wheeler segment.

Retail Deposits

During fiscal 2003, ICICI continued its focus on retail deposits. This has reduced its funding cost and has enabled it to create a stable funding base, with over 4.7 million deposit customers. Following a life stage segmentation strategy, ICICI Bank offers differentiated liability products to various categories of customers depending on their age group (Young

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Star Accounts for children below the age of 18 years, Student Banking Services for students, Salary Accounts for salaried employees, Roaming Current Accounts for businessmen, Private Banking for high net worth individuals and Senior Citizens Accounts for individuals above the age of 60 years). ICICI Bank has further micro-segmented various categories of customers in order to offer products catering to specific needs of each customer segment, like defence banking services for defence personnel. This strategy has contributed significantly to the rapid growth in the retail liability base.

Credit Cards

ICICI Bank is also the largest incremental issuer of cards (including both debit and credit cards) in India. At March 31, 2003, ICICI Bank had issued over 3.4 million debit cards and 1.0 million credit cards. Its multi-channel distribution strategy provides its customers 24%7 accesses to banking services. This distribution strategy not only offers enhanced convenience and mobility to the customer but also supports its customer acquisition and channel migration efforts.

Electronic Channels

During the year, ICICI has expanded its electronic channels and migrated large volumes of customer transactions to these channels. Seventy percent of customer induced transactions take place through electronic channels.

ATMs

During fiscal 2003, the Bank significantly strengthened its ATM network, taking the total number of ICICI Bank ATMs to 1,675. ICICI Bank has also pioneered the concept of mobile ATMs to reach out to remote/rural areas. Other facilities offered through multilingual screen ATMs include bill payments and prepaid mobile card recharge facility. ICICI bank is also planning to share the network with other key players in financial services market to give a wider access to its customers.

Internet Banking

ICICI Bank has about 3.4 million customers with Internet banking access, who can undertake all their banking transactions (other than physical cash transactions) on the Internet. ICICI Bank's Internet banking customers can also pay their bills for more than 45 billers and shop on 85 online shopping portals.

Phone Banking

ICICI Bank considers phone banking to be a key channel of service delivery and cross-sell. ICICI Bank's 1,750-seat call centre, the largest domestic call centre in India, can now be accessed by customers in over 355 cities across the country. The call centre handles more than 2.5 million customer contacts per month. The call centre services all retail customers across the ICICI group. The call centre uses state-of-the-art voice-over-Internet-protocol technology and cutting-edge desktop applications to provide a single view of the customer's relationship.

Mobile Banking

ICICI Bank's mobile banking services provide the latest information on account balances previous transactions, credit card outstanding and payment status and allow customers to request a cheque book or account statement. ICICI Bank has now extended its mobile banking services to all cellular service providers across the country and NRI customers in the United States, United Kingdom, Middle East and Singapore.

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Service Delivery through Multi-channel Distribution Network

With the foundation of a strong multi-channel distribution network, it has successfully developed a robust model for distribution of third party products like mutual funds, Reserve Bank of India (RBI) relief bonds, and insurance products, with market leadership in these areas. This model also allows it to meet all customer needs by offering the customer the complete basket of financial products, while leveraging its distribution capability to earn fee income from third parties.

Online Trading

ICICI direct (www.icicidirect.com) is the market leader in Internet based share trading, with complete end-to-end integration for seamless electronic trading on stock exchanges. ICICI direct has a rating of "TXA1" from CRISIL, indicating highest ability to service broking transactions. During the year, ICICI direct launched online trading in the derivatives segment of the NSE.

Question

1. What problem Mr. Bhargava Dasgupta is facing in this case?
2. What recommendations will you make to Mr. Bhargava Dasgupta? Should he go global? Give your reasons.

Source: www.icicibank.com/

8.5 Summary

- Corporate banking represents a wide range of banking and financial services provided to domestic and international operations of large local corporates and local operations of multinational corporations.
- Price is a mechanism to cover the costs of operations which comprises of production costs, distribution costs, promotion costs, and other operational expenses.
- The transition from sellers market to buyers market has compelled the bankers to understand the pulse and needs of the customers. With interest deregulation in the sector of deposits with the sole exception of Savings Bank Account, where the apex monetary authority continues to decide the rate of interest, rest of the fields are open for competition.
- Monitoring of the account is easier in retail lending segment as compared to the conventional advances, for the reason that installments and repayment schedule have to be monitored in respect of retail lending.
- The contribution brought in by the borrower is termed as margin. Margin requirements differ from one type of finance to others and they differ from one bank to the other.
- Merchant Banking is a combination of banking and consultancy services that banks provide to its customers.
- The concept of venture financing became more popular during the sixties and seventies, when several private enterprises undertook the financing of high-risk and high reward projects.
- Merchant bankers provide advice on acquisition propositions after careful examination of all aspects.

Notes

- Treasury management can be described as the management of cash, funds, currency, bank and financial risk. That's why it is an imperative tool of finance. Cash inflows and outflows are checked by finance manager.

8.6 Keywords

Benchmark Prime Lending Rate (BPLR): The BPLR is the interest rate that commercial banks charge their most credit-worthy customers.

Core Banking Solutions: Core banking is a term used to describe the services provided by a group of interconnected bank branches.

Export-Import Banks: It is the principal financial institution in the country for coordinating the working of institutions engaged in financing exports and imports.

Floating Rate Certificates of Deposits (FRCDs): A floating rate certificate of deposit issued by a bank that pays a monthly, quarterly, semi-annual, or annual coupon based on a floating interest rate.

Floating Rate Notes (FRN): A floating rate note, often called an FRN or "floater", is a debt instrument that pays a floating interest rate.

Lease: A lease is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset.

London Interbank Bid Rate (LIB/D): The average interest rate which major London banks borrow Eurocurrency deposits from other banks.

Technical Consultancy Organization (TCO): Technical Consultancy Organisations (TCOs) were created for facilitating technical consultancy for industrial projects.

8.7 Review Questions

1. Write short note on corporate banking.
2. What kinds of services are offered by corporate banking?
3. What do you understand by retail lending schemes?
4. Briefly describe saving accounts.
5. Define merchant banking. Explain significance and its functions.
6. What type of loans is issued on foreign currency?
7. What do you mean by treasury management?
8. Write an essay on the objectives and functions of treasury management.
9. Describe portfolio management.
10. What activities are included in corporate counselling?

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	Finance	6.	currency risk
7.	liquidity	8.	False

Notes

9. True
10. False
11. True
12. Equity
13. Foreign
14. Dates
15. Documents

8.8 Further Readings

Books

Hajols. T. N (2009), *"Money and Banking"*, Gopaljee Enterprises.

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Rajesh, R, Sivagnanansithi, T (2009), *"Banking Theory: Law and Practice"*, Tata McGraw Hill Publishing Company Ltd.

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Notes

Unit 9: Cash Management System

CONTENTS

Objectives

Introduction

9.1 Concept of Cash Management Services (CMS)

9.2 Evolution and Need of Cash Management Services (CMS)

9.2.1 Need of CMS

9.3 Concept of Cash Management Services for Corporate Entity in India

9.4 Summary

9.5 Keywords

9.6 Review Questions

9.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the concept of Cash Management Services
- Discuss the evolution and need for CMS
- Discuss the concept of CMS for Indian corporate entity

Introduction

In the previous unit, we dealt with the concept of various banking systems such as corporate banking, retail banking, merchant banking and treasury management. This unit will help you to understand the concept of cash management services provided by banks to several corporate entities. To execute, collect receivables and manage liquidity, efficient cash management processes are mandatory. The most significant players in the Indian financial market are the banks. They are the biggest providers of credit, and also attract most of the savings from the population. The banking industry, mostly dominated by public sector, has so far acted as an efficient partner in the growth and the development of the country. Public sector banks have long been the supporters of agriculture and other priority sectors. They act as crucial channels of the government in its attempts to ensure equitable economic development.

Cash Management services is a newcomer in the Indian Banking Scenario. CMS is a mechanism to efficiently handle cash flow in order to cut-down risks, minimize costs and maximize profits. Generally Cash Management constitutes integrated collection, payments, liquidity management, and receivables functions. Speedy collection of outstation instruments is one of the major products under CMS.

9.1 Concept of Cash Management Services (CMS)

Cash management is a term which pertains to the collection, concentration, and disbursal of cash. It comprehends a bank's degree of liquidity, its management of cash balance, and its short-term investment schemes.

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Caution Managing cash flow is the most important task in today's scenario.

Efficient cash management demands proper outflow and inflow of cash to improve liquidity and returns while enforcing adequate controls to manage risks.

Notes Cash management is achieving trade-off between liquidity and profitability.

Cash management relates to a broad area of finance requiring the collection, handling, and use of cash. It involves evaluating market liquidity, cash flow, and investments. Cash management refers to a number of services that banks tend to offer clients such as large businesses. While many individuals may use savings or checking accounts and other services furnished by banks, cash management services tend to be those designed for clients with more complex financial needs. Some of the most common types of cash management services are account reconcilement, advanced web services, lock box, cash collection, and armoured car services.

Account reconcilement is one of the most commonly used cash management services. This is a service that is planned for businesses that write a large number of cheques each month. Cheques do not always clear right away, meaning that balances are not always easy to determine. In order to gain a higher level of transparency, account reconcilement enables businesses to get full list of each and every cheque written in a month, allowing employees to see which cheques have cleared, which are pending, and what the projected balance of the account should be after all pending cheques have been deposited and cleared.

Many banks offer cash management services that include advanced web services. These first allow employees to create log-ins that are more complex than typical consumer log-ins for greater security. The higher degree of security enables employees to send money to other locations, accounts, clients, and entities, as well as manage cash in ways that most individual and small business consumers do not have access to. Lock boxes are generally provided by banks to large clients who are looking for cash management services. This is a service that allows clients that receive a large number of checks in the mail to set up their own box in the post office. A representative from the bank opens the box, removes the cheques, and deposits them into a proper account.

Banks offer cash collection service to clients who have accounts with a number of other banks. These clients tend to have locations in a number of geographical locations, including places where a branch of the main bank is not available. This cash management service provides clients with the ability to consolidate the cash from a number of different accounts into one account that is able to collect interest from the primary bank.

Armoured car service is one of the cash management services that many large businesses await. It allows businesses to have large sums of real cash, as well as other valuable assets, transported from location to location with increased security and protection. An armoured car normally transfers cash from the bank to the business and from the business location back to the bank.

Financial instruments involved in cash management include money market funds, treasury bills, and certificates of deposit.

Did u know? The Reserve Bank of India (RBI) has placed an emphasis on upgrading technological infrastructure to manage cash efficiently. Electronic banking, cheque imaging, Enterprise Resource Planning (ERP), Real Time Gross Settlements (RTGS) are just few of the new initiatives for efficient cash management.

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There are a number of regulatory and policy changes that have facilitated an efficient Cash Management System (CMS).

Example: The Enactment of Information Technology Act gives legal recognition to electronic records and digital signatures.

The formation of the Clearing Corporation of India in order to establish a safe and dependable institutional structure for the clearing and settlement of trades in foreign exchange (FX), money and debt markets has surely helped the growth of financial infrastructure in terms of clearing and settlement. Other innovations that have supported in contouring the process are:

- Introduction of the Centralized Funds Management Service to facilitate better management of fund flows.
- Structured Financial Messaging Solution, a communication protocol for intra-bank and interbank messages.

Self Assessment

Fill in the blanks:

1. Cash management is a term which pertains to the ....., ..., and ..... of cash.
2. Cash management is achieving trade-off between .....and .....
3. Account reconcilement is one a service that is planned for businesses that write .....
4. ..... is a service that allows clients that receive a large number of checks in the mail to set up their own box in the post office.
5. ..... allows businesses to have large sums of real cash, as well as other valuable assets, transported from location to location with increased security and protection.

9.2 Evolution and Need of Cash Management Services (CMS)

One of the rising cash management services in India is payment outsourcing. Though cheques and drafts are a popular mode of payment in India, it is evidently a time consuming procedure because of the manual processing required. This is a domain where payment outsourcing can help. It helps the corporate to cut-down their overheads and focus on their core competencies and, as a result, benefit from speed and accuracy. The heightened security it offers also allows for tighter fraud control. For the Indian payment system to become completely seamless there are many variables that need to be harnessed, such as regulatory and legal issues, customer behaviour and infrastructure.

As more corporate and banks have added technology to their procedures, the issues surrounding connectivity security have become much important. Today, treasurers need to ensure that they are equipped to make the best decisions. For this, it is essential that the information they require to monitor risk and exposure is accurate, authentic and fast. A strong cash management solution can give corporate a business advantage and it is very important in performing the financial strategy of a company. The requirement of an efficient cash management solution in India is to carry out payments, collect receivables and handling liquidity. Traditional or e-business objectives, in India there are different cash management solutions.

9.2.1 Need of CMS

Managing liquidity is complex, as cash is volatile. For a business spread across various locations, managing outstation fund-collections and disbursements can often be a time-consuming,

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expensive and aggravating proposition. Delays of days or even weeks in actualizing outstation cheques, constant tracking and review to transfer funds from outstation collection accounts, uncertainty and delays regarding information on the fate of the cheque is common. These affect the company's liquidity position and it has to bear a higher interest cost. A cure to this hazard is the practice of cash management.

Besides, often they find it difficult to have access to funds at the required time since banks pass on the credit only on realisation. Corporate are not certain of the delay to get the instruments collected through normal channel of banks and get the funds credited to their accounts which blocks the treasury management portfolio and strain their liquidity and profitability. Cash Management offers guaranteed credit and timely MIS.

CMS brings certainty of cash flows and helps in liquidity management. Sectors such as telecom, utility services, mutual funds and insurance companies benefit most from it because they can syndicate their receipts from different locations in different forms in a seamless manner.

Caselet

Purple Software Solutions' Missed Opportunities

In Shahadara, Delhi, Mr Gulab Kohli starts a business in the name of Purple Software Solutions by the capital he inherited after his father sold his toy manufacturing business and died later in the year 1999. Since the money he invested initially was more than his business needed, Mr Gulab Kohli spent it in maintaining his office lavishly and when questioned about the same by his wife, he replied that it was all to attract customers. Obviously, he concentrated more on office maintenance that was required. Also he had this habit of maintaining some 25 lac rupees in cash at home so that if and when required, he could spend it. On his also, his wife questioned him once, to which he said that they may require cash anytime, and since he has a lot of it, there is no harm in keeping it safely at home.

Later on, when he needed funds for following up his prospective clients, he started falling short of cash. Reason is for anybody to guess. He spent the money on wrong heads. And sooner or later, the cash he kept at home had to deplete. As a result of this, he incurred huge losses and to close his business.

Source: C. Gulati Neelam (2010), *"Principles of Banking Management"*, Excel Books.

Self Assessment

Fill in the blanks:

6. One of the rising cash management services in India is .....
7. A ..... can give corporate a business advantage.
8. CMS brings certainty of ..... and helps in .....

9.3 Concept of Cash Management Services for Corporate Entity in India

CMS offers tailor-made collection and payment services, which allow companies to shrink the realisation time of cheques and streamline their cash flows. As the companies get access to their funds faster, the need for companies to borrow cash comes down, and lowers their interest payout. In return, the banks charge the companies a fee, based on the intensity of the transaction,

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the location of the cheque collection centre and speed of delivery. Some banks even buy the cheques and pay the corporate immediately; charging an interest fee for the number of days it takes them to encash the cheques. Since CMS allows companies to track their cash flows on a daily basis, financial decisions happen faster and more efficiently. The following is a list of services generally offered by banks and utilized by larger businesses and corporations:

1. ***Account reconciliation:*** Balancing a cheque book can be a difficult procedure for a very large business, since it affects so many cheques it can take a lot of human monitoring to realize which cheques have not cleared and therefore what the company's true balance is. To cover this, banks have developed a system which allows companies to upload a list of all the checks that they issue on a daily basis, so that at the end of the month the bank statement will show not only which checks have cleared, but also which have not. Lately, banks have used this system to prevent cheques from being fraudulently cashed if they are not on the list, a process known as positive pay.

2. ***Advanced web services:*** Most banks have an Internet-based system which is better than the one available to consumers. This helps the managers to create and empower special internal log-on credentials, permitting employees to send wires and access other cash management features normally not found on the consumer web site.

3. ***Armoured car services/cash collection:*** Large retailers who collect a great deal of cash may have the bank pick this cash up via an armoured car company, instead of asking its employees to deposit the cash.

4. ***Automated clearing house:*** It is usually offered by the cash management division of a bank. The automated clearing house is an electronic system used to transfer funds between banks. Companies use this to pay others, especially employees (this is how direct deposit works). Certain companies also use it to collect funds from customers (this is generally how automatic payment plans work).

5. ***Balance reporting:*** Corporate clients who actively manage their cash balances usually subscribe to reliable web-based reporting of their account and transaction information at their lead bank. These advanced compilations of banking activity may include balances in foreign currencies, as well as those at other banks.

6. ***Cash concentration services:*** Large or national chain retailers are often in areas where their primary banks do not have branches. Therefore, they open bank accounts at various local banks in the area. To prevent funds in these accounts from being slug and not earning sufficient interest, many of these companies have an agreement with their primary bank, whereby their primary bank uses the automated clearing house to electronically "pull" the money from these banks into a single interest-bearing bank account.

7. ***Controlled disbursement:*** In this the bank provides a daily report, typically early in the day, that provides the amount of disbursements that will be charged to the customer's account. This early knowledge of daily funds requirement allows the customer to invest any surplus in intraday investment opportunities, typically money market investments. This is different from delayed disbursements, in which payments are made through a remote branch of a bank and customer is able to delay the payment due to increased float time.

8. ***Lockbox - wholesale services:*** Often companies which receive a large number of payments via cheques in the mail have the bank set up a post office box for them, open their mail, and deposit any cheques found. This is referred to as a "lockbox" service.

9. ***Lockbox - retail services:*** Lockbox are for companies with small numbers of payments, sometimes with detailed requirements for processing.

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10. ***Positive pay:*** Positive pay is a service whereby the company electronically shares its check register of all written checks with the bank. This system dramatically reduces cheque fraud.

11. ***Reverse positive pay:*** Reverse positive pay is similar to positive pay, but the process is reversed, with the company, not the bank, maintaining the list of cheques issued. In reverse positive pay, the bank sends that file to the company, where the company compares the information to its internal records. The company lets the bank know which cheques match their internal information, and the bank pays those items. The bank then researches the cheques that do not match, corrects any misinterprets or encoding errors, and determines if any items are deceitful. The bank pays only "true" exceptions, that is, those that can be settled with the company's files.

12. ***Sweep accounts:*** Sweep accounts are generally offered by the cash management division of a bank. Under this system, excess funds from a company's bank accounts are automatically moved into a money market mutual fund overnight, and then moved back the next morning. This allows them to earn interest overnight.

13. ***Zero balance accounting:*** Zero balance accounting is pretty much like a hack. Companies with large numbers of stores or locations can very often be confused if all those stores are depositing into a single bank account. It would be impossible to know which deposits were from which stores without referring to the images of those deposits. To help rectify this problem, banks developed a system where each store is given their own bank account, but all the money deposited into the individual store accounts are automatically moved or swept into the company's main bank account. This allows the company to look at individual statements for each store.

14. ***Wire transfer:*** A wire transfer is electronic transfer of funds. Wire transfers can be done by a simple bank account transfer, or by a transfer of cash at a cash office. Bank wire transfers are often the most expedient method for transferring funds between bank accounts. A bank wire transfer is a message to the receiving bank requesting them to effect payment in accordance with the instructions given. The message also includes settlement instructions. The actual wire transfer itself is virtually instantaneous, requiring no longer for transmission than a telephone call.

Cash management services can be costly but usually the cost to a company is outweighed by the benefits: cost savings, accuracy, efficiencies, etc.

Task Make a report on the concept, evolution and need of Cash Management Services in India.

Self Assessment

Fill in the blanks:

9. ..... is usually offered by the cash management division of a bank.
10. Lockbox are for companies with .....
11. ..... is a service whereby the company electronically shares its check register of all written checks with the bank.
12. In ..... excess funds from a company's bank accounts are automatically moved into a money market mutual fund overnight, and then moved back the next morning.
13. A ..... is electronic transfer of funds.

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Case Study

Revision in Cash Management System at Indian Oil Corporation Limited

This case study details the revision in the Cash Management System at Indian Oil Corporation Limited (IOCL), one of India's leading oil companies. As of FY 2010-2011, IOCL had 540 locations around India which served as an outlet for its finished products. The historical analysis draws on the process of receiving collections and payment methods on a day-to-day basis from each of these locations. This study also helps in understanding the Cash Management Product (CMP) and Cash Management Services (CMS) facilities provided by State Bank of India (SBI) and HDFC Bank respectively. It describes the centralized collection system and the decentralized payment system of IOCL. The introduction of Electronic Collections (e-Collections) e.g. RTGS, CORE TO CORE, NEFT, ECS, INTERNET BANKING etc. facility with a view to generating the credit receipt to the customer account in SAP at the earliest provides valuable insights into the advantages of the new system . IOCL registered around 82% of various collections through the e-collection modes. The case study also looks at budgeting of cash flows, i.e. inflows and outflows, and the analysis of variance from the actual. It involves understanding and evaluating various sources of short-term borrowings by IOCL to meet daily cash requirements and other payments which are necessary along with the daily collections. This case can be used with MBA/ MS students as a part of their Financial Management curriculum.

Indian Oil Corporation Ltd. (IOCL) was India's largest company by sales with a turnover of ₹ 12710.740 billion and profit of ₹ 102.210 billion for the year 2009-10. Considered an important pillar of the Indian Economy, IOCL was India's largest commercial enterprise and flagship national oil company and downstream petroleum major. It operated the largest and widest network of fuel stations in the country. In 2010, IOCL had a market share of 41% in refining, 54% in product pipelines, and 46% in the petroleum products market. By financial year 2010-11, IOCL had 14 products, besides delivering excellent quality services and loyalty programs such as "extra care", extra rewards", and "extra premium easy fuel cards". It was a major supplier to core sectors such as the Army, the Railways, State Road Transport Corporations, the Air Force, the Navy, Power, and Aviation. IOCL revised its Cash Management System or Treasury Management System in the year 2006-07.

Management of cash is extremely crucial for any organization as mismanagement can lead to financial distress. Cash management helps in short-term stability and long-term survival. In order to handle business effectively and grow in terms of quantum sales and profits, it is essential for a company to establish an adequate and positive cash flow order.

IOCL started with centralizing the whole collection system and slowly moved toward centralization of the complete payment system. This was a sign of further flexibility in treasury functions.

Oil Industry Background in India

The Indian oil industry is categorized into three segments based on their operations: the Upstream, the Downstream, and the other industrial bodies.

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Upstream

Upstream operations are confined to production and exploration of energy resources. India has 26 sedimentary basins spanning 3.14 million sq. km of which 1.35 million sq. km are under deep water. A substantial part remains unexplored or poorly explored. Domestic production grew by 5.6 per cent in 2006-07 to 33.98 million ton (mt) from 32.19 mt in 2005-06; it had increased to 34.11 mt during 2007-08.

However, India still has a long way to go in exploration and production (E&P), being one of the least explored countries in the world.

Downstream

Downstream operations include refining and marketing of petroleum products. Refining is an industrial process where crude oil is processed and refined into more useful petroleum products, such as gasoline, diesel fuel, asphalt base, heating oil, kerosene, and liquefied petroleum gas. The refinery capacity in the country was 178 MMTPA (million metric tonnes per annum) at the end of 2008-09. As of 2011, there were 17 refineries in India of which seven were owned by Indian Oil Corporation Ltd. (IOCL). Only one refinery, Reliance Petroleum's plant at Jamnagar, was wholly owned by a private company. The Jamnagar facility was Reliance Petroleum's only refinery, but it was India's largest, with a capacity of 660,000 barrels per day.

India had the global opportunity of emerging as a leading refinery centre in the world. Since 2006, the worldwide demand for petroleum products had grown by around 2.5 percent, while the rate of refining capacity addition had been only around 0.7 percent. No new refineries had been set up in the US and Europe in the last 20 years due to strict environmental norms. The high refining margins had led to a rush by Indian companies to meet the deficit for petroleum products. Also India's favourable geographical presence alongside major sea routes gave it an edge in the areas of refining and exporting crude oil.

Company Structure

All the branches of IOCL worked under the Corporate Office located at New Delhi, India. It followed a hierarchical structure where the decision flowed from the top to the bottom and information flowed from the bottom to the top. Under the corporate office there were four divisions - Pipelines, Refineries, Research and Development, and Marketing.

Earlier Cash Management System

An organization's cash operating cycle is the complete process of utilizing its resources and converting them into income through trading activities. Prior to the establishment of the Cash Management Product (CMP) module in IOCL in 2006-07, the transactions took place through the conventional method using the Regional Cash Credit (RCC) module.

Current Cash Management System

As for IOCL, as a marketing organization, the cash management process involved a number of depots, terminals, bottling plants, etc. and every unit was responsible for purchasing and selling products all over India. There was a need to have close control over the collection mechanism so as to meet daily payment requirements. After a transaction, the banking department of IOCL started its function only when the money got deposited in the respective bank branches and the bank generated an MIS. Generation of MIS from a bank branch was a very important part from IOCL's point of view as real work on the transaction took place.

Contd...

Notes

Being a huge organization, the majority of IOCL's transactions took place through e-collections and while the rest were through instruments i.e. cheques, demand drafts, letters of credit, etc. A very few were in cash with a negligible amount being involved. SBI provided for a completely customized SBI FAST (CMP) facility to IOCL. The project pioneered, initiated, and implemented by IOCL was the largest fully automated B2B implementation in India. This project helped the company make exchanges happen throughout the length and breadth of the country and connect to all suppliers and the stakeholders.

Banking Arrangements

There were two collection modes in IOCL: Non E-Collection Modes and E-Collection Modes. With Internet banking becoming a necessity in the business world, IOCL with the help of its bankers introduced the concept of E-collections within its working environment. Indian Oil Corporation, as stated earlier, had a centralized collection system whereas its payment mechanism was totally decentralized, i.e. Funds would flow through all the regional offices or state offices to the Head Office.

Cash Flow Forecasting

A key element of cash management involved projections of inflows and outflows of cash by the corporation. It also required constant updating on a day-to-day basis for ensuring effective fund management.

Projections were done in two stages:

- Monthly: by the 7th of every month
- Rolling: by the 22nd of every month for the next month.

For effective forecasting, managers at IOCL required credible information from multiple sources. The process of cash flow forecasting was on a daily/monthly basis, and employed forecasting by three months moving average, forecasting by OCC seasonal index, and forecasting by five years' trend analysis.

Though IOCL used a centralized collection system, it had a decentralized payment system. In early 2011, it started a centralized payment system but restricted it to employee payments. However, IOCL had plans to eventually centralize the whole payment system.

Questions

1. Discuss the about IOCL and its organization structure.
2. Explain the banking arrangements.
3. Explain the Cash Flow Management and Cash Budgeting in IOCL.

Source: http://www.icmrindia.org/casestudies/catalogue/Finance/FINC075.htm

9.4 Summary

- To execute, collect receivables and manage liquidity, efficient cash management processes are mandatory.
- CMS is a mechanism to efficiently handle cash flow in order to cut-down risks, minimize costs and maximize profits. Generally Cash Management constitutes integrated collection, payments, liquidity management, and receivables functions.
- Cash management is a term which pertains to the collection, concentration, and disbursal of cash.

Notes

- Efficient cash management demands proper outflow and inflow of cash to improve liquidity and returns while enforcing adequate controls to manage risks.
- Financial instruments involved in cash management include money market funds, treasury bills, and certificates of deposit.
- Cash Management offers guaranteed credit and timely MIS.
- CMS brings certainty of cash flows and helps in liquidity management.
- Account reconciliation is system which allows companies to upload a list of all the checks that they issue on a daily basis, so that at the end of the month the bank statement will show not only which checks have cleared, but also which have not.
- Automated clearing house is an electronic system used to transfer funds between banks.
- Lockbox are for companies with small numbers of payments, sometimes with detailed requirements for processing.
- Positive pay is a service whereby the company electronically shares its check register of all written checks with the bank.

9.5 Keywords

Account reconcilement: The process of confirming that two separate records of transactions in an account are equal.

***Advanced web services*:** These services helps the managers to create and empower special internal log-on credentials.

Cash Management System (CMS): Cash Management Services (CMS) is a mechanism to efficiently manage cash flow in order to reduce risks, minimize costs and maximize profits.

Disbursement: Amounts paid for goods and services that may be currently tax deductible.

Lock boxes: It allows clients that receive a large number of checks in the mail to set up their own box in the post office.

***Reverse positive pay*:** A service that transmits to a company issuing checks a file of checks presented for payment, this is matched to the company's data for check fraud, which is then returned.

Sweep Accounts: A bank account that automatically transfers amounts that exceed (or fall short of) a certain level into a higher interest earning investment option at the close of each business day.

Zero Balance Accounts: A checking account in which a balance of zero is maintained by automatically transferring funds from a master account in an amount only large enough to cover checks presented.

9.6 Review Questions

1. Write short notes on:
   (a) Account reconciliation
   (b) Advanced web services
   (c) Automated clearing house
   (d) Cash concentration services

Notes

(e) Controlled disbursement

(f) Positive pay

(g) Sweep accounts

(h) Zero balance accounting

2. Discuss on the concept of cash management system.
3. Elaborate on the need of cash management system in banking.
4. "Cash Management Services has eased the functioning in banking sector." Explain.
5. Explain the evolution of CMS.

Answers: Self Assessment

1.	Collection, concentration; disbursal	2.	Liquidity; profitability
3.	A large number of cheques each month	4.	Lock boxes
5.	Armoured car service	6.	Payment outsourcing
7.	Strong cash management solution	8.	Cash flows; liquidity management
9.	Automated clearing house	10.	Small numbers of payments
11.	Positive pay	12.	Sweep accounts
13.	Wire transfer		

9.7 Further Readings

Books

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Unit 10: Negotiable Instruments

Notes

CONTENTS

Objectives
Introduction
10.1 Cheques
10.1.1 Definition of a Cheque
10.1.2 Features of a Cheque
10.1.3 Parts of a Cheque
10.1.4 Types of Cheque
10.1.5 Dishonour of Cheques
10.1.6 Crossing of Cheques
10.1.7 Endorsement of Cheques
10.2 Bills of Exchange
10.2.1 Definition of Bills of Exchange
10.2.2 Special Characteristics of Bills of Exchange
10.3 Promissory Note
10.3.1 Definition of Promissory Note
10.3.2 Parties to a Promissory Note
10.3.3 Essentials of a Promissory Note
10.4 Holder
10.5 Paying Banker and Collecting Banker
10.5.1 Rights and Liabilities of Paying and Collecting Banker
10.6 Summary
10.7 Keywords
10.8 Review Questions
10.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Define cheque, bills of exchange and promissory note
- Explain the features of cheque
- Discuss the concept of holder and holder in due course
- Discuss rights and liabilities of paying and collecting banker
- Describe crossing and dishonour of cheques
- Explain endorsement of a cheque

Notes

Introduction

Previous unit dealt with cash management services provided by banks to its corporate customers. In this unit you will study all types of negotiable instruments and their various aspects. "Negotiable instruments are written orders or unconditional promises to pay a fixed sum of money on demand or at a certain time." Bills of exchange, checks, promissory notes, drafts, and certificates of deposit are all examples of negotiable instruments. Negotiable instruments may be transferred from one person to another, who is known as a "holder in due course". This transfer is also known as negotiation of the instrument and upon transfer, the holder in due course obtains full legal title to the instrument. The transferred by delivery or by endorsement and delivery.

10.1 Cheques

A very common form of negotiable instrument is a cheque. A cheque is similar to a bill of exchange; the only difference being that the bank is always the drawee in case of a cheque.

10.1.1 Definition of a Cheque

"Cheque is an instrument in writing containing an unconditional order, addressed to a banker, signed by the person who has deposited money with the banker, requiring him to pay on demand a certain sum of money only to or to the order of certain person or to the bearer of instrument."

The Negotiable Instruments Act, 1881 defines a cheque as: "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand."

The person who draws a cheque is called the 'drawer'. The banker on whom it is drawn is the 'drawee' and the person in whose favour it is drawn is the 'payee'. In other terms, a cheque is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer.

10.1.2 Features of a Cheque

A cheque possesses the following features:

i. ***Cheque is an instrument in writing:*** Oral orders are not considered as cheques.

Caution A cheque must be in writing.

ii. ***Cheque contains an unconditional order:*** Every cheque contains an unconditional order issued by the customer to his bank. A cheque containing conditional orders is considered invalid and is dishonoured by the bank.

iii. ***Cheque is drawn by a customer on his bank:*** A cheque is always drawn on a specific bank mentioned in that. Cheque book facility is made available only to account holder who is supposed to maintain certain minimum balance in the account.

iv. ***Cheque must be signed by customer:*** A cheque must be signed by customer, i.e. the account holder. Unsigned cheques or cheques signed by persons other than customers are not regarded as cheque.

v. ***Cheque must be payable on demand:*** A cheque when presented for payment must be paid on demand. If cheque is made payable after the expiry of certain period of times then it will not be a cheque.

Notes

vi. ***Cheque must mention exact amount to be paid:*** Cheque must only be for money. The amount to be paid by the banker must be certain and written in words as well as figures.

vii. ***Payee must be certain to whom payment is made:*** The payee of the cheque should be certain whom the payment of a cheque is to be made i.e. either real person or artificial person like Joint Stock Company. The name of the payee must be written on the cheque or it can be made payable to bearer.

viii. ***Cheque must be duly dated by customer of bank:*** A date must be duly mentioned by the customer of bank. A cheque is valid for a period of six months from the date of issue.

ix. Cheque has three parties**:**

(a) *Drawer:* A drawer is a person, who draws a cheque.

(b) *Drawee:* A drawee is a bank on whom a cheque is drawn.

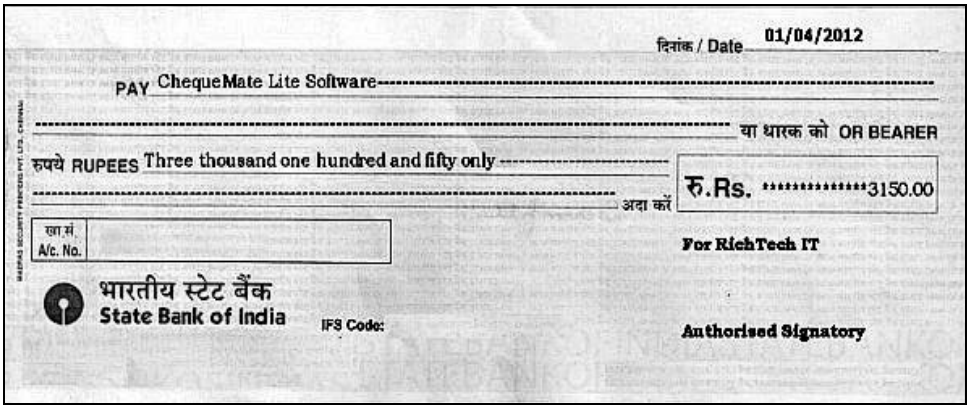
(c) *Payee:* A payee is a person in whose favour a cheque is drawn.

10.1.3 Parts of a Cheque

The four parts of a cheque are:

1. ***Drawee:*** The party directed to pay the amount of a draft or check.
2. ***Drawer:*** The party who draws the draft upon another party for payment.
3. ***Payee:*** The person to whom a cheque, money order, etc., is made out.
4. ***Amount:*** The amount that is to be paid.

Figure 10.1: Format of an SBI Cheque


दिनांक / Date 01/04/2012
PAY ChequeMate Lite Software
या धारक को OR BEARER
रुपये RUPEES Three thousand one hundred and fifty only
अदा करें
रु.Rs. **********3150.00
खा.सं. A/c. No.
For RichTech IT
भारतीय स्टेट बैंक
State Bank of India
IFS Code:
Authorised Signatory

Source: www.richtechindia.com

10.1.4 Types of Cheque

1. ***Bearer Cheque:*** When the words "or bearer" which appear on the face of the cheque are not cancelled, the cheque is called a bearer cheque. The bearer cheque is payable to the person specified therein or to any other else who presents it to the bank for payment. However, such cheques are risky because if they are lost, the one who finds it can collect money from the bank.
2. ***Order Cheque:*** When the word "bearer" appearing on the face of a cheque is cancelled and in its place the word "or order" is written on the face of the cheque, it is called an order

Notes

cheque. Such a cheque is payable to the person specified in that as the payee, or to anyone else to whom it is endorsed.

3. ***Uncrossed/Open Cheque:*** A cheque is called an "open cheque" when it is not crossed. It is also known as an "uncrossed cheque". The payment of such a cheque can be obtained at the counter of the bank. It can be an order cheque or a bearer one.

4. ***Crossed Cheque:*** Crossing of cheque means drawing two parallel lines on the face of the cheque with or without additional words like "& CO." or "Account Payee" or "Not Negotiable". A crossed cheque can only be credited to the payee's account.

5. ***Anti-dated Cheque:*** If a cheque is presented to the bank after the date that is mentioned on it, it is called as "anti-dated cheque". Such a cheque is valid up to 6 months from the date of the cheque.

6. ***Post-dated Cheque:*** If a cheque bears a date which is yet to come, then it is known as post-dated cheque. A post dated cheque cannot be honoured earlier than the date on the cheque.

7. ***Stale Cheque:*** If a cheque is presented for payment after six months from the date of the cheque it is called stale cheque. A stale cheque is not honoured by the bank.

10.1.5 Dishonour of Cheques

According to Section 138 of the Negotiable Instruments Act, 1881:

"Dishonour of cheque for insufficiency etc., of funds in the account.—Where any cheque drawn by a person on an account maintained by him with the banker for payment of any amount of money to another person from out of that account for the discharge, in whole or in part, of any debt or other liability, is returned by the bank unpaid, either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an arrangement made with that bank, such person shall be deemed to have committed an offence and shall, be deemed to have committed an offence and shall, without prejudice to any other provision of this Act, be punished with imprisonment for a term which may extend to one year, or with fine which may extend to twice the amount of the cheque, or with both."

Reasons for Dishonour of Cheques

Following are the various reasons for dishonour of cheques:

- ***Insufficient fund:*** When the amount written on a cheque is more than what the drawer has in his account in the bank.
- ***The death of the drawer:*** If the bank receives information of the death of its customer, the bank won't honour any cheque presented on the account of the dead customer, until further notice.
- ***Irregular signature:*** If the signature on the cheque differs from the specimen signature in the bank.
- ***Non-existing account:*** Sometimes, scammers who have no bank account but possess false cheque books may issue cheque to those whom they have conned.
- ***Bankruptcy:*** If one is judged by a law court to be unable to pay his debts in full, the bank will dishonour any cheque presented on behalf of that customer.
- ***Frozen account:*** If court orders or a military government rules that some people's account be frozen, the bank must definitely dishonour all checks bearing the account's numbers.

Notes

- ***When there is attention:*** If anything is cancelled on a cheque, the bank will dishonour such a check, except the drawer signs his signature above or under the altered word.
- ***A post-dated check:*** If this is presented for payment, the bank will dishonour such a cheque.
- ***A stale cheque:*** A cheque presented for repayment after 6 months of the date written on it, such a kind of cheque must be dishonoured by the bank.
- ***If there is a difference between the amount written in words and that in figures:*** If for instance, the drawer writes thirty dollars only in words and $20 in figure.
- ***When payment is stopped:*** If the drawer asks a bank not to pay a cheque already issued.

The proceedings of a cheque bounce case generally take an average of 1 year before the trial court. The important stages in a cheque bounce case are:

1. ***Filing of complaint:*** The complaint needs to be registered before the magistrate within 30 days from the accrual of claim and the complainant should be present at the time of filing of complaint. The original documents are presented to the magistrate. If prima-facie a case is made out, the magistrate posts the matter for sworn statement.
2. ***Sworn Statement:*** A sworn statement is also known as "affidavit". At this stage, the complainant needs to enter the witness box and give further details pertaining to the case. If the magistrate is satisfied that there is some meaning in the case of the complainant, then he will issue a summon to the accused.
3. ***Appearance of Accused:*** The accused needs to appear in the court on receiving the summons. In case of non-appearance, the court issues an arrest warrant against him. After appearance, the accused is supposed to take a bail from the court with or without securities. If the accused is unable to furnish a security then he can deposit a cash security. This cash security is refundable to the accused after the closing of the case.
4. ***Recording of Plea:*** In the next stage, the court asks the accused as to whether he has committed the offence or not. If the accused admits the guilt, the court immediately gives him punishment. If he pleads innocence, the court posts the matter for proof.
5. ***Evidence:*** The complainant furnishes his evidence, generally by way of affidavit; this is known as examination-in-chief. He needs to produce all documents in support of his case like bounced cheque, dishonour memo, copy of notice etc. Later, complainant is cross examined by the accused. If there are other witnesses in support of the complainant, then their evidence is also recorded.
6. ***Statement of the Accused:*** After the complainant side evidence is over, the court puts some questions to the accused regarding his guilt. An accused needs to give his version to the same.
7. ***Defense Evidence:*** After the accused statement the court gives an opportunity to the accused to leave his evidence. The accused can also produce documents as well as witnesses in support of his case. Accused and his witnesses are cross examined by the complainant. After this, the case is posted for arguments.
8. ***Arguments:*** Both the complainant and the accused will submit their arguments before the court. They can also submit judgments of high courts and Supreme Court in support of their case. Normally a written argument containing a gist of the oral argument is also presented to the court.
9. ***Judgement:*** After the arguments, case is posted for judgement. If the court finds that the accused has committed offence, he is punished with fine or imprisonment. If he is innocent,

Notes

the court will discharge him. If accused is pronounced, then he needs to suspend his sentence, for a period of 30 days with in which time, he can file an appeal before the sessions court.

Task Visit your nearest bank and find out the common reasons for dishonour of cheque that are known by the bank officials.

10.1.6 Crossing of Cheques

Crossing is a popular practice devised for protecting the drawer and payee of a cheque in case it is lost, stolen or the signature is done by some other person for endorsing it. Both bearer and order cheques can be crossed. Crossing prevents fraud and faulty payments. Crossing of a cheque means "Drawing Two Parallel Lines" across the front of the cheque. Thus, crossing is essential in order that safety is maintained.

Notes Crossed cheques must be presented through the bank only because they are not encashed at the counter.

Different Types of Crossing

Cheques can be crossed in following ways:

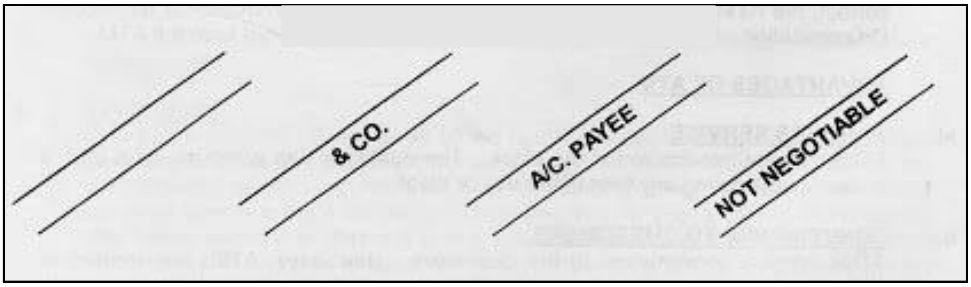
General Crossing: Generally, cheques are crossed when there are two transverse parallel lines, marked across its face or the cheque bears an abbreviation "& Co." between the two parallel lines or the cheque bears the words "Not Negotiable" between the two parallel lines or the cheque bears the words "A/c. Payee" between the two parallel lines.

A crossed cheque can be made bearer cheque by cancelling the crossing and writing that the crossing is cancelled and affixing the full signature of drawer.

Generally, cheques are crossed when:

- There are two transverse parallel lines, marked across its face, or
- The cheque bears an abbreviation "& Co. "between the two parallel lines, or
- The cheque bears the words "Not Negotiable" between the two parallel lines, or
- The cheque bears the words "A/c. Payee" between the two parallel lines.

Figure 10.2: Specimen of General Crossing



Source: http://kalyan-city.blogspot.com/

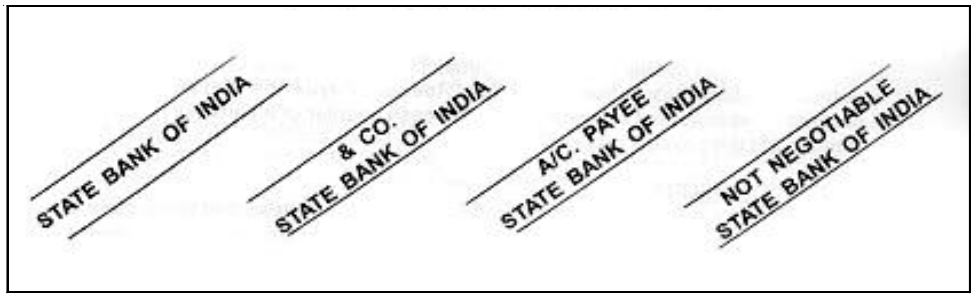
Notes

Special or Restrictive Crossing: Section 124 of the Act refers to Special crossing as:

"Where a cheque bears across its face in addition to the name of the banker either with or without the words or the words 'not negotiable, then the cheque is said to have been crossed specially. The object of special crossing is to direct the banker to pay the cheque only if it is presented through the particular bank mentioned."

When a particular bank's name is written in between the two parallel lines the cheque is said to be specially crossed.

Figure 10.3: Specimen of Special Crossing



Source: http://kalyan-city.blogspot.com/

In addition to the word bank, the words "A/c. Payee Only", "Not Negotiable" may also be written. The payment of such cheque is not made unless the bank named in crossing is presenting the cheque. The effect of special crossing is that the bank makes payment only to the banker whose name is written in the crossing. Specially crossed cheques are safer than generally crossed cheques.

General Crossing	Special Crossing
1. Drawing of two parallel transverse lines is a must.	1. Drawing of two parallel transverse lines is not essential.
2. Inclusion of the name of a banker is not essential.	2. Inclusion of the name of a banker is essential.
3. In General Crossing paying banker honours the cheque from any bank A/C.	3. In Special Crossing paying banker honours the cheque only when it is presented through the bank specified in the crossing and no other bank.
4. General Crossing can be converted into a Special Crossing.	4. Special Crossing can never be converted to General Crossing.
5. In case of General Crossing the words "And Company" or "& Company" or "Not Negotiable" between the transverse lines to highlight the crossing does not carry special significance.	5. In case of Special Crossing the name of a banker may be written within two parallel transverse lines or with the words "And Company" or "Account Payee Only" or "Not Negotiable" the inclusion of these words has become customary.

Double Crossing: A cheque is said to be doubly crossed when it bears 2 separate special crossings. As per section-127, "where a cheque is crossed specially to more than one banker except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof." Thus a paying banker shall pay a doubly crossed cheque only when the second banker is acting just as the agent of the first collecting banker and this has been clearly mentioned on the instrument.

Notes

Who can cross a cheque?

(a) A cheque may be crossed generally or specially by the drawer.

(b) Holder may also cross it.

(c) Holder may turn a general crossing into special crossing.

(d) A banker may cross an uncrossed cheque & he may cross it especially to himself or to another banker for purpose of collection through him.

The above content is confirmed by section 125 of Negotiable Instruments Act, 1881.

Opening of crossing/cancellation of crossing: A crossed cheque becomes an open cheque if the crossing on it is cancelled and this is known as "opening of crossing". Only the drawer of the cheque has the right to open the crossing of the cheque by writing the words "Pay Cash" and cancelling the crossing along with his full signature. His initials are not enough for this purpose.

The paying banker must be very careful in ascertaining the validity or genuineness of the drawer's signature opening the crossing. If drawer's signature (already on the cheque) is forged by the holder in order to open the crossing and the payment is obtained at the counter, the banker will remain liable to the true owner of the cheque. The banker is under an obligation to pay the cheque according to the directions conveyed through the crossing on the cheque.

10.1.7 Endorsement of Cheques

The act of signing a cheque for the purpose of transferring it to somebody else is known as "Endorsement". Under Negotiable Instruments Act this means writing of one's name on the back of the instrument or any paper attached to it with the purpose of transferring the rights therein. Endorsements are usually made on the back of the cheque, though they can be made on its face as well. If, however, no space is left on the instrument, it may be made on a separate paper attached to it.

A bearer cheque can be transferred by mere delivery but an order cheque is transferred by endorsement and delivery.

Endorsement on the cheque must be made in proper manner, or the bank will not pay it. The endorser must sign his name exactly as it is written on the cheque. He must sign his name with the same spellings as it appears on the cheque. He may also put down the correct spellings after he has signed in the manner already appearing on the cheque. Where a cheque is endorsed on behalf of a company, a firm or some other institution, the person signing the endorsement must sign so as to make it clear that he is doing it on behalf of the company or the firm and not in his personal capacity.

Types of Endorsement

According to the N.I. Act, 1881 endorsement can be done in any of the following forms:

1. Endorsement in blank or general endorsement.
2. Endorsement in full or special endorsement.
3. Restrictive endorsement.
4. Partial endorsement.
5. Conditional endorsement.

Notes

These are discussed as below:

- ***Endorsement in Blank or General Endorsement:*** In this case, the payee or endorser does not specify an endorsee and he simply signs his name (Sec. 16, NIA).
- ***Endorsement in Full or Special Endorsement:*** When the endorser specifies the person to whom or to whose order the instrument is to be paid, the endorsement is called special endorsement or endorsement in full. The specified person i.e. the endorsee then becomes the payee of the instrument.
- ***Restrictive Endorsement:*** When an endorsement prohibits further negotiation of a negotiable instrument, it is said to be restrictive. Section 50 of the NI Act 1881states, "The endorsement may, by express words, restrict of exclude the right to negotiable or pay constitute the endorsee an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person."

Example: If B endorses an instrument payable to barer as follows, the right of C to further negotiate is excluded.

  - Pay the contents to C only
  - Pay C for my use

- ***Partial Endorsement:*** If only a part of the amount of the instrument is endorsed, it is called partial endorsement. An endorsement which proposes to transfer to the endorsee only a part of the amount payable, or which aims to transfer the instrument to two or more endorsees individually, is not valid.
- ***Conditional Endorsement:*** If the endorser of a negotiable instrument, by express words in the endorsement, makes his liability or the right of the endorsee to receive the amount due thereon, dependent on the happening of a specified event, although such event may never happen, such endorsement is called a conditional endorsement (Section 52 of NI Act). Such an endorser gets the following rights:
  - He may make his liability on the instrument conditional on the happening of a particular event.
  - He will not be liable to the subsequent holder if the specified event does not take place to the instrument even before the particular event takes place.

Example: "Pay C if he returns from London". Thus C gets the right to receive payment only on the happening of a particular event, i.e. if he returns from London.

Effect of Endorsement: An unconditional endorsement of a negotiable instrument followed by its unconditional delivery has the effect of transferring the property in that to the endorsee. The endorsee acquires a right to negotiate the instrument further to anyone he wishes.

Section 50 of NI Act also permits that an instrument may also be endorsed so as to constitute the endorsee an agent of the endorser.

- To endorse the instrument further or,
- To receive its amount for the endorser or for some other specified person.

Notes

Self Assessment

State whether the following statements are true or false:

1. A cheque can be either in written form or in oral form.
2. A cheque can be conditional or unconditional.
3. The amount on the cheque should be written in both numbers and figures.
4. A cheque is valid for a period of 6 months.
5. Drawer is the one who draws the cheque.
6. A crossed cheque can be encashed either at the cash counter of the bank or to the payee's account.
7. Under Negotiable Instruments Act, writing one's name at the back of the instrument is called an "endorsement".

10.2 Bills of Exchange

Bills of exchange are similar to cheques and promissory notes. They can be drawn by individuals or banks and are generally transferable by endorsements.

Did u know? The difference between a promissory note and a bill of exchange is that a bill of exchange is transferable and can bind one party to pay a third party that was not involved in its creation.

- If these bills are issued by a bank, they can be referred to as bank drafts.
- If they are issued by individuals, they can be referred to as trade drafts.

10.2.1 Definition of Bills of Exchange

A bill of exchange can be defined as follows:

"A non-interest-bearing written order used primarily in international trade that binds one party to pay a fixed sum of money to another party at a predetermined future date."

10.2.2 Special Characteristics of Bills of Exchange

An instrument, in order to amount in law to as bill of exchange, must fulfil the following conditions:

1. ***It must be in Writing:*** A bill of exchange cannot be oral. It must always be in written document. Although it's not necessary to use particular words and nor is it required to set form in which alone a bill of exchange can be drawn. Provided the document fulfils the above conditions laid down by law it will amount to a bill of exchange, whatever its form may be. Writing includes printing.
2. ***Signed by the Maker:*** A bill, not signed by the drawer, is regarded in law as an "inchoate bill". The signature of the drawer may not be appended to the document at the time it is drawn but until this is done, the bill is not inchoate and ineffective in law. So, no action can be brought by a holder against acceptor on a bill which is unsigned by the drawer. Signature includes a mark and even an impressed or litho stamp.

Notes

3. ***It must contain an Order:*** Though no particular form of words is necessary to form a valid bill, it is required that the words used must amount to an "order". In other words, they must not be precatory, i.e. amounting to as mere request.
4. ***Which must been Unconditional:*** It is of importance for a bill that the order directing payment should be unconditional, i.e. the payment should not be dependent on the happening as eventuality or the fulfilment of a condition.
5. ***It must direct a certain person:*** The drawee must be certain. There can be joint drawee of bill but not alternate or successive drawee. Also, if the drawee's name is wrongly mentioned, evidence may lead to prove who was the person really intended.
6. ***To pay certain sum of Money Only:*** The amount to be paid must be expressed in terms of money only.
7. ***To a Certain Person or his Order or to Bearer:*** The bill must be drawn and made payable either to a certain person or his order to bearer. In this connection it has been recently held in England that a document drawn payable to "cash or order" is not a bill of exchange as it is not made payable "to or to the order of any specified persons or bearer".
8. ***It must be properly stamped:*** Art. 13 of the Stamp Act lay down the proper stamp for bills of exchange. Generally speaking, notice stamp is chargeable on a bill payable only demand. A bill must be properly stamped when necessary. In absence of a proper stamp, the bill may be in admissible in evidence (sec. 35, Stamp Act). Notice that under sec. 46, the making (acceptance or endorsement) of a bill of exchange is not completed till delivery thereof, either actual or constructive.

In short, before a document can be called a bill of exchange, the following things must be certain:

- Drawer
- Order
- Drawee
- Payee
- Sum payable

These are popularly called the "five certainties" of a bill of exchange.

The following points regarding bills of exchange should also be kept in mind in case of a bill of exchange.

- ***Figures:*** the bill at the top or bottom corner mentions the amount in figures. The act provides that where the sum payable is expressed in words is the amount payable (sec.18).
- ***Date:*** the date is mentioned in order to compute maturity of bill. That date is by law regarded as the date of the issue of the bill. A bill is not invalid because it is undated. Evidence may be adduced to prove the date of its issue. As bill may been antedated or post dated.
- ***Place of issue is also mentioned:*** This is to determine whether it is an "inland "or a "foreign" bill.
- ***"For vale received":*** the words though typically found in bills of exchange are really superfluous, consideration being always presumed in case of negotiable instrument (sec.118) and also because consideration can always be proved by external evidence.

Notes

Self Assessment

Fill in the blanks:

8. Difference between a promissory note and a bill of exchange is that a bill of exchange is .....
9. A bill not signed by the drawer is called as a/an ..... bill.
10. The amount to be paid must be expressed in terms of .....

10.3 Promissory Note

A promissory note is a term used for a legal document that declares the intention of an individual or an entity to pay an amount on demand or at a specified time. A promissory note can be written on the face value of a debt or for an amount that would include accumulated interest.

A promissory note is simply a "promise to pay." It contains a maker, i.e. the payer and a lender, i.e. the payee. An unsecured promissory note is not attached to anything; the loan is made on the basis of the maker's ability to repay. A secured promissory note may also be made based on the maker's ability to repay, but it is secured by a thing of economic value such as a car or a house.

Caselet

Damodar. S. Prabhu v. Sayed Babalal-SC of India: Impact of Section 147 of Negotiable Instruments Act

This case decided by Supreme Court on Section 147 of the Negotiable Instruments Act speaks upon a new scheme to be adopted by the courts while dealing with cheque bounce cases. As there are reportedly more than 38 lakhs of cheque cases pending in different courts in India, this decision has laid down a simple working formula which could be said as one safe step towards preserving the object of Section 138 and Section 147 of the Negotiable Instruments.

Object of Section 138 explained: The decision reiterates the statutory principle and object as a result of which the Section has come into force. The section has been inserted into the Negotiable Instruments Act (hereinafter referred as 'Act') by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988 with an object to underline the faith in the banking operations and credibility in transactions using negotiable instruments. The section has laid down certain specifications, penalties etc. in the case of bouncing of cheques. The amendment to the section in 2002 increased the punishment duration as two years imprisonment.

Object of Section 147 explained: Section 147 in the Act fill the element of compounding which Section 320 left out. Thus the legislative vacuum with regard to compounding of cheque bouncing cases has been filled by Section 147. It is interesting to note that the statement of objects and reasons for the 2002 Amendment in the Act, it is described that the deficiencies of Sections 138 to 142 of the Act in dealing with dishonour of cheques was one of the reason behind insertion of Section 147.

Guidelines Lay Down

1. Modification of summons to the effect that the accused could make an application for compounding of the offence at the first or second hearing of the case. If an application is made, the Court can allow compounding the offence without costs.

Contd...

Notes

2. If such an application is not made at the earlier stage and made only at a later subsequent stage of the case, compounding can be allowed with a cost of additional 10% of the cheque amount to be deposited with such authority which the Court deems fit.

3. The percentage of cost varies in appeal stage viz., 15% in Sessions or High Court and 20% in Supreme Court.

The decision further clarified that the Court can in its discretion reduce the costs. The grading scheme as to costs is intended to encourage compounding at an early stage of litigation. The time of Court also can be saved. In this case the Court also made a direction to disclose by affidavit along with the complaint to state that there is no other claim in any other court as to the same cause of action.

Source: http://www.scribd.com/doc/86299846/Case-Study-on-Negotiable-Instruments

If your home is used for security and you fail to pay the promissory note, you could lose your home. Most promissory notes attached to property are secured by a trust deed (deed of trust), a mortgage or a land contract, and those instruments are recorded in the public records. Promissory notes are often unrecorded.

10.3.1 Definition of Promissory Note

"A written, signed, unconditional promise to pay a certain amount of money on demand at a specified time. A written promise to pay money that is often used as a means to borrow funds or take out a loan."

The individual who promises to pay is the **maker**, and the person to whom payment is promised is called the **payee** or holder. If signed by the maker, a promissory note is a negotiable instrument. It contains an unconditional promise to pay a certain sum to the order of a specifically named person or to bearer—that is, to any individual presenting the note. A promissory note can be either payable on demand or at a specific time.

10.3.2 Parties to a Promissory Note

A promissory note has the following parties:

- The maker: the person who makes or executes the note promising to pay the amount stated therein,
- The payee: one to whom the note is payable,
- The holder: is either the payee or some other person to whom he may have endorsed the note,
- The endorser,
- The endorsee.

10.3.3 Essentials of a Promissory Note

To be a promissory note an instrument must possess the following essentials:

- It must be in writing. An oral promise to pay will not do.
- It must contain an express promise or clear undertaking to pay. A mere acknowledgement of debt is not sufficient.

Notes

- The promise or undertaking to pay must be unconditional. A promise to pay "when able", or "as soon as possible", or "after your marriage", is conditional. But a promise to pay after a specific' time or on the happening of an event which must happen, is not conditional.
- The maker must be a certain person, i.e., the note must show clearly who the person is engaging himself to pay. .
- The payee must be certain. The promissory note must contain a promise to pay to some person or persons validated by a name or designation.
- The sum payable must be certain and the amount must not be capable of contingent additions or subtractions.
- Payment must be in legal money of the country.
  - It must be properly stamped in accordance with the provisions of the India Stamp Act. Each stamp must be duly cancelled by maker's signature or initials.
  - It must contain the name of place, number and the date on which it is made.

However, their omission will not make the instrument invalid, e.g. if it is undated, it is assumed to be dated on the date of delivery.

Notes A promissory note cannot be made payable or issued to bearer, no matter whether it is payable on demand or after a certain time (Section 31 of the RBI Act).

Self Assessment

Fill in the blanks:

11. In case of a promissory note, an individual who promises to pay is known as the .....
12. The person to whom the payment is promised is known as the .....
13. According to ..... of RBI Act, a promissory note cannot be made payable or issued to bearer, no matter whether it is payable on demand or after a certain time.

10.4 Holder

According to Section 8 of the Act a person is a holder of a negotiable instrument who is entitled in his own name-

(i) to the possession of the instrument, and

(ii) to recover or receive its amount from the parties thereto.

It is not every person in possession of the instrument who is called a holder. To be a holder, the person must be named in the instrument as the payee, or the endorsee or he must be the bearer thereof. A person, who has obtained possession of an instrument by theft, or under a forged endorsement, is not a holder. As he is not entitled to recover the instrument. The holder implies de jure (holder in law) holder and not de facto (holder in fact) holder. An agent holding an instrument for his principal is not a holder although he may receive its payment.

"A holder is an individual who is in possession of an instrument that is either payable to him or her as the payee, endorsed to him or her, or payable to the bearer. Those who obtain instruments

after the payee are holders if such instrument is either payable to the bearer or endorsed properly to their order. The party in possession is not considered to be the holder in a case in which a necessary endorsement has been forged."

Holder in Due Course

Section 9 states that a holder in due course is:

i. a person who for consideration, obtains ownership of a negotiable instrument if payable to bearer, or

ii. the payee or endorsee thereof, if payable to order, before its maturity and without having enough cause to consider that any defect subsisted in the title of the person from whom he deduced his title.

In order to be a holder in due course, a person must satisfy the following conditions:

- He must be the holder of the instrument.
- He should have obtained the instrument for value or consideration.
- He must have obtained the negotiable instrument before maturity.
- The instrument should be complete and regular on the face of it.
- The holder should take the instrument in good faith.

"A holder in due course is in a privileged position. He is not only himself protected against all defects of the persons from whom he received the instrument as current coin, but also serves as a channel to protect all subsequent holders. A holder in due course can recover the amount of the instrument from all previous parties, although, as a matter of fact, no consideration was paid by some of the previous parties to the instrument or there was a defect of title in the party from whom he took it." Once an instrument passes through the hands of a holder in due course, it is purged of all defects. It is like current coin. Whoever takes it can recover the amount from all parties previous to such holder.

Self Assessment

Fill in the blanks:

14. A person who has obtained the possession of an instrument by ..... is not a holder.

15. A holder in due course is a ..... position.

10.5 Paying Banker and Collecting Banker

Paying banker and collecting banker can be defined as follows:

"The bank on which a cheque is drawn (the bank whose name is printed on the cheque) and which pays the amount for which the cheque is written and deducts that sum from the customer's account." The paying banker should use due care and diligence in paying a cheque so as to refrain from any action potential enough to damage his customer's credit.

"A Collecting banker is the one who attempts to collect different types of instruments representing money in favour of his customer or his own behalf from the drawers of these instruments; some are negotiable instruments as provided for in the Negotiable Instruments Act, 1881."

Notes

10.5.1 Rights and Liabilities of Paying and Collecting Banker

Rights and liabilities of a both types of bankers can be discussed as follows:

Rights of Paying and Collecting Banker

The rights of the banker include:

1. ***Right of General Lien:*** can be retained till the owner discharges the debt or obligation to the possessor. A lien is the right of a creditor in possession of goods, securities or any other assets belonging to the debtor to retain them until the debt is repaid, provided that there is no contract express or implied, to the contrary. A banker has the right to retain the property belonging to the customer until the debt due from him has been paid. It is a right to retain possession of specific goods or securities or other movables of which the ownership vests in some other person and the possession

2. ***Right to set off:*** The right of set off is also known as the right of combination of accounts. Right to set off is a right of the banker to adjust his outstanding Joan (debit) in the name of the customer from his credit balance of any of the accounts he s maintaining with the bank. A bank has a right to set off a debt owing to a customer against a debt due from him. Right to set off is nothing but combine the two or more accounts of a customer of the customer. If the customer have two or more account and in case of absence of agreement the banker can exercise has right of set off:

   (a) The two or more accounts must be in the name of same customer

   (b) There must be same capacity

   (c) There must be same bank ,though different branches

   (d) One account should show debit balance and other should show a credit balance

   (e) The debt must be manual

   (f) The amount of debit should be certain one.

   Thus set off is adjustment of debit balance with that of credit balance

3. ***Right to close an account:*** There should be no confusion between closing the account and stopping operation of the account. The contractual relationship between banker and customer is terminated by closing the account. There is no opportunity for the customer to operate the account once again. On the other hand, stopping operation of an account refers to the suspension of the operation of an account for the time being, at the advent of certain events. It is purely suspension of the relationship between a banker and a customer and the customer can operate the account, after such events come to a close

   The circumstances for closure of account are:

   (a) Customer's intension to close the account

      i. The customer can close the account in any of the following condition

      ii. If he does not agree to the terms of the banker such as rate of interest, bank charges etc

      iii. If the customer does not enjoy such facilities as are offered by some other banks e.g. free transfer of money up to ₹ 10000

      iv. When the confidence of the person is shaken

Notes

(b) Bankers intention to close the account

i. The banker can close the account of the customer when he finds

ii. The account is not remunerative

iii. When the customer is not a desirable one.

(c) Customer's death-as soon as the bank gets notice of the death of the customer, he should immediately stop the operations of the account. It is because death puts an end to the contract.

(d) Customers insanity-the banker should stop the operation of his account .the banker should apply for the official copy of Lunacy Order.

(e) Customers insolvency-when the banker comes to know that the customer is insolvent than the bank will close the account of the customer.

4. ***Right to appropriate payments:*** The banker has the right to appropriate the money deposited by a customer to any one of the loan account due by him. The appropriation arises when the customer has more than one account one showing the debit balance and the other with a credit balance. The customer is given the first option to decide the account to which the amount should be credited. If the customer fails to indicate his choice then the banker has every legal right to credit the amount in any one account of that customer.

Liabilities of Paying Bankers

Following are the liabilities of paying bankers:

- Checking the signature of the drawer.
- Verification of the genuineness of the instrument.
- Payment not stopped by the A/c holder
- Holder's title on the cheque is valid.
- A/c is not dormant one.
- A/c holder is not bankrupt or deceased.
- A/c is not under subject of liquidation process.
- No 'Guernsey Order' is issued by court.
- Properly endorsed.
- Cheque is not drawn beyond limit fixed by the drawer is respect of amount.
- Instrument being presented is crossed.
- Instrument is not state or post dated.
- No material adjustment is made.
- Sufficient balance in the A/c

Liabilities of Collecting Bankers

Following are the liabilities of collecting bankers:

1. ***Acting as agent:*** While collecting an instrument, the Bankers works as agent of his customer. As an agent he has to take some steps & precautions to protect the interest or his customer as a man of ordinary discretion would take to safeguard his own interest.

Notes

2. ***Scrutinizing the instruments:*** Name of the holder, Branch name, amount in world and figure, date, material alteration of any to be checked carefully.
3. ***Checking the endorsement:*** Bankers have to check the instrument whether it has been endorsed properly.
4. ***Presenting the instrument in due time:*** It is the responsibility of the collecting bank to present the instrument in due time to the paying bank.
5. ***Collecting the proceeds in the payee's account:*** It is the duty of collecting banks to collect and credit the proceeds of the instruments to the proper/correct account.
6. ***Notice of dishonour and returning the instruments:*** If any instrument is dishonoured by the paying bank it should be informed to the customer on the day following the receipt of the unpaid instruments.

Self Assessment

Fill in the blanks:

16. Acting as agent is a ..... of a collecting Banker.
17. Bankers have to check the instrument whether it has been …….. properly.
18. Liability of Paying Banker is to check that no ..... is issued by court.

Case Study

Enforceability of Lost or Destroyed Negotiable Instruments/Commercial Paper

It is an interesting case that shows the how lost or destroyed Negotiable Instruments/ Commercial Paper can remain enforceable is Atlantic National Trust, LLC v. Mcnamee, 2007. The High Court in Alabama held that a destroyed promissory note is still enforceable both the maker of the note, or an assignee could enforce it so long as its existence could be proven.

In this case a bank (Wachovia) made a loan in 2003 to the debtor, McNamee, in the amount of US $150,000. For this he signed a promissory note. At some point, Wachovia inadvertently misplaced, lost or destroyed the original note. The note matured in 2005 and after the loan matured Wachovia assigned its rights in and to the note to the plaintiff Atlantic National Trust., which then sued for recovery. Atlantic demanded McNamee repay the remaining principal balance of US $138,620 plus interest.

The plaintiff moved for summary judgment based on an affidavit affirming that the instrument had been lost by the assignor. Now Atlantic could not produce the original note, but had a copy, so the debtor defended on the grounds that the plaintiff assignee had no right to enforce the note since it was never in possession of the original document, and that the assignee of a lost note has no standing to sue the maker. Thus McNamee contended that because the original note was destroyed, the note could not be enforced. The federal court certified a question to the Alabama High Court to clarify Alabama common law on that issue.

It was concluded that an assignee has all of the same rights, benefits, and remedies that the assignor has to enforce contracts to the extent the assignor was able to do so, hence the

Contd...

Notes

plaintiff assignee was entitled to enforce the note whether it was lost, destroyed, or stolen. Ultimately the evidence was clear that the note was genuine, the fact of the destruction of the original did not make it unenforceable either by the maker of the note, Wachovia, or by the assignee, Atlantic.

Question

What implications does this have in the greater financial industry and banking sector?

Source: http://pklawyers.wordpress.com/2008/11/23/enforceability-of-lost-or-destroyed-negotiable-instrumentscommercial-paper/

10.6 Summary

- Negotiable instruments are written orders or unconditional promises to pay a fixed sum of money on demand or at a certain time
- A cheque is a document that orders a payment of money from a bank account.
- Check that is returned unpaid by the bank on which it was drawn due to lack of sufficient funds. To knowingly issue a check that will be dishonoured is a criminal offence in many jurisdictions.
- Section 123 of the Act refers to general crossing as- "Where a cheque bears across its face two traverse lines with or without the words or the words 'not negotiable, the cheque is said to have been crossed generally. Where a cheque is crossed generally, the banker shall not pay it, otherwise than to the banker"
- Section 124 of the Act refers to Special crossing as- "Where a cheque bears across its face in addition to the name of the banker either with or without the words or the words 'not negotiable, then the cheque is said to have been crossed specially. The object of special crossing is to direct the banker to pay the cheque only if it is presented through the particular bank mentioned."
- A cheque is said to be doubly crossed when it bears 2 separate special crossings. As per section-127, "where a cheque is crossed specially to more than one banker except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof."
- Cheque has 3 parties **:** Drawer, Drawee and Payee
- The act of signing a cheque for the purpose of transferring it to somebody else is known as "Endorsement".
- A non-interest-bearing written order used primarily in international trade that binds one party to pay a fixed sum of money to another party at a predetermined future date.
- A promissory note is a term used for a legal document that declares the intention of an individual or an entity to pay an amount on demand or at a specified time.
- A holder is an individual who is in possession of an instrument that is either payable to him or her as the payee, endorsed to him or her, or payable to the bearer. Those who obtain instruments after the payee are holders if such instrument is either payable to the bearer or endorsed properly to their order. The party in possession is not considered to be the holder in a case in which a necessary endorsement has been forged.
- A Collecting banker is the one who attempts to collect different types of instruments representing money in favour of his customer or his own behalf from the drawers of these instruments

Notes

10.7 Keywords

Cheque: a written order directing a bank to pay money;

Drawee: The party directed to pay the amount of a draft or check.

Drawer: The party who draws the draft upon another party for payment.

Endorsement: The act of signing a cheque for the purpose of transferring it to somebody else.

Payee: The person to whom a cheque, money order, etc., is made out.

Promissory Note: promise to pay

Sworn Statement: also known as "affidavit"

10.8 Review Questions

1. Discuss the history of Indian Banking System.
2. Elaborate on the present scenario of banking system in India.
3. Discuss the role and functions of RBI.
4. Explain what are cheque and the different types of cheques.
5. Elaborate the liabilities of collecting banker and paying banker.
6. What do you understand by holder and holder in due course?
7. Explain the special characters of bills of exchange.
8. What are the different types of endorsements? Explain.

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	True	6.	False
7.	True	8.	Transferable
9.	Inchoate	10.	Money
11.	Maker	12.	Payee
13.	Section 31	14.	Theft, or under a forged endorsement
15.	Privileged	16.	Liability
17.	Endorsed	18.	Guernsey Order

10.9 Further Readings

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Notes

Unit 11: Banking Sector Reforms

CONTENTS

Objectives

Introduction

11.1 First Generation Reform

11.2 The Second Phase of Reforms

11.2.1 Narasimham Committee Report (ii)

11.3 Liberalization of Banking Sector

11.3.1 Three Features of Liberalization

11.4 Summary

11.5 Keywords

11.6 Review Questions

11.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the first generation reforms
- Explain the second phase of reforms
- Discuss the recommendations given by Narsimham Committee (i) & (ii)
- Elaborate on the liberalization of banking sector

Introduction

In the previous unit, we dealt with several negotiable instruments like bills of exchange, promissory note, paying banker, collecting banker, cheques, etc. The unit also discussed about the reasons for dishonour of cheques. This unit will help you to understand the liberalization of banking sector and various reforms. The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain for example, lack of an interbank interest rate benchmark, an active corporate debt market and a developed derivatives market.

On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.

However, financial liberalization alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt

companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.

11.1 First Generation Reform

With effect from 1st February 1969, the government imposed "social control" on banks. Soon after the first nationalization of 14 major banks on 19th July 1969, the government appointed the Saraiya Commission in 1969, to examine the banking system and recommended ways to make it efficient in working in coordination with government policies for national economic development. One of the main recommendations of the committee was related to the reconstruction of the banking system into 8 or 9 banks, consisting of 3 all-India banks, SBI and 2 of the nationalized banks plus 5 or 6 regional banks with overlapping jurisdiction over the neighbouring areas, this was not accepted. However, almost all the recommendations of the commission regarding bank's operations so as to simplify the credit procedure and rationalize the internal control system and organisational management were accepted. Accordingly, Section 19 of the Banking Regulation Act 1949 was amended to allow the banks to form subsidiaries.

Owing to 1991 crisis of balance of payment, the government appointed the Narsimham Committee on 14th August, 1991. It submitted its report, known as its first report, on 16th November 1991. The first phase of banking sector reform which began during 1992-93 was based on twin principles of "Operational Flexibility" and "Functional autonomy".

Narsimham Committee Report (I)

The Government of India constituted a Committee under the Chairmanship of Sh. M. Narasimham, former governor, Reserve Bank of India to examine the structure and functioning of the existing financial system of India and suggest suitable reforms. The main recommendations were as follows:

- ***SLR & CRR:***
  - SLR to be brought down to 25% over a period of 5 years.
  - The interest of SLR securities should be market oriented.
  - CRR to be reduced progressively and interest rate on CRR to be fixed at the level of bank's one-year deposit.
- ***Priority Sector Lending:***
  - The target of priority sector lending to be reduced to 10% of total credit.
  - Priority sector credit to be redefined, and subsidy in development programmes may be withdrawn
- ***Interest Rates:***
  - Interest rates on Govt. securities to be in line with market rates.
- ***Capital Adequacy:*** Banks to achieve Capital Adequacy Norms as under:
  - Foreign banks to achieve 8% norm by March 1993.
  - Indian Banks having branches abroad to achieve 8% by March 1994.
  - Other Indian Banks to reach 4% by March 1993 and 8% by March 1996.
- ***Accounting Policies:***
  - Investment portfolio to be bifurcated into permanent and current category and full provisions must be made for depreciation in case of current category.

Notes

- Classification of loan assets into four categories namely, (i) Standard Assets, (ii) Sub-standard assets, (iii) Doubtful assets and (iv) Loss assets.
- For Standard, Sub-standard, Doubtful and Loss assets provisioning should be done on the following basis: Standard 0.25% (w.e.f. 31.03.2000); Sub-standard 10% of total outstanding; Doubtful Asset 100% of security shortfall plus 20%, 30% or 50% depending on the age of doubtful advance and Loss assets 100% of outstanding.

Income Recognition

In case of non-performing assets, no interest should be recognised unless it is actually received.

- ***New Institution:***
  - Special recovery Tribunals (Debt Recovery Tribunals) to be set up for speedy recovery of bank dues.
  - Asset Reconstruction fund to be formed to take over the bad and doubtful debts from banks.
- ***Entry of Private Sector Banks:***
  - No further nationalisation of banks.
  - No difference in treatment between public sector and private sector banks.
  - No bar to open banks in private sector.
  - More foreign banks should be allowed to open branches in India.
- ***Branch Licensing Policy:*** Branch licensing policy to be abolished.
- ***Staff Related Issues:***
  - A portion of the posts in different cadres should be filled up from the open market in view of the need for special expertise.
  - Accelerated promotion opportunities to skilled and talented officers of proven merit.
  - Banks to recruit officers directly and clerks through BSRBs.
  - A panel of eminent persons should select chairman and MDs/EDs.
  - RBI need not have representation in Bank Boards.
- ***Supervision of Financial Sector:***
  - The duality of control over banking system by RBI and by Banking Division of Ministry of Finance should be stopped. RBI should be the primary agency to regulate the banking system.
  - RBI should review the directions given by the government with a view to decide on their relevance.
  - A quasi-autonomous Banking Supervisory Board (Board for Financial Supervision) to be set up for supervision of banks and financial institutions.
- ***Legislative Measures:***
  - The Banking Companies (Acquisition and Transfer of Undertaking) Act 1970/1980 to be amended to raise paid up capital and raise equity from the market.
  - Banking Regulation Act to be amended to give effect to transparency and disclosure.

Notes

- RBI Act 1934 to be amended to allow the banks to perform all types of banking business.

Self Assessment

Fill in the blanks:

1. More foreign banks should be allowed to open …….. in India.
2. A portion of the posts in different cadres should be filled up from the open market in view of the need for special ……
3. Banking Regulation Act to be amended to give effect to ……. and ……
4. The first phase of banking sector reform which began during 1992-93 was based on twin principles of "Operational Flexibility" and "…… autonomy".

11.2 The Second Phase of Reforms

The second phase of reforms envisaged greater autonomy to priority sector banks with respect to recruitment and promotion of staff, better asset liability management, lesser external intervention and pressures etc. The focus of the banks will, therefore, be on profit maximisation, NPA recovery management and diversification through merger, acquisition and participation with peers in the market.

11.2.1 Narasimham Committee Report (ii)

In 1998 the government appointed yet another committee under the chairmanship of Mr. Narsimham. It is better known as the Banking Sector Committee. It was told to review the banking reform progress and design a programme for further strengthening of financial system of India. The committee focused on various areas such as capital adequacy, bank mergers, bank legislation, etc. The main points that were highlighted in the report were:

- RBI should withdraw from 91 days T Bill market. Inter-bank and call money and term money markets should be restricted only to banks and primary dealers.
- Minimum shareholding by the government/RBI in the equity of nationalised banks and SBI should be brought down to 33%. RBI directors should be withdrawn from bank boards.
- 5% risk weight is considered for market risk for government and approved securities. Government guaranteed advances, that have turned sticky, should be treated as NPAs.
- Banks should attain a minimum CRR of 9% by 2000 AD and 10% by 2002 AD.
- Accrual of interest for income recognition should be done in 90 days instead of 180 days.
- Minimum startup capital needs for foreign banks should be raised from US $10 million to US $25 million. This capital should be brought in one go and not in phases. Foreign banks should be allowed to set up subsidiaries or joint ventures in India and these should be treated on par with other private banks.
- Bank Chairman should be given a minimum of three years at the helm. Need to de-link salaries of bank and FIs chiefs and whole-time directors from the civil services pay scale.
- All loans in doubtful/loss category should be identified and their realisable value determined. These assets could be transferred to an asset reconstruction company which would issue NPA swap bond to the banks.

Notes

- SBI's associate banks should be constituted on the lines of Nationalised Banks with CMD and two whole time directors. No need for SBI Chairman to be ex-officio Chairman of these banks.
- The startup requirements of ₹ 100 crore for new private sector banks should be hiked. Restriction on promoters voting right (at present 10%) should be done away with provided the promoter group does not hold more than 14% of equity.

Assessment of the Financial Sector Reforms

Financial Sector Reforms can be assessed as follows:

- While India's financial reforms have been comprehensive and in line with global trends, one unique feature is that, unlike with other planned economies, the Indian Government did not engage in a drastic privatisation of public sector banks. Rather it chose a gradual approach towards restructuring these banks by enhancing competition through entry deregulation of foreign and domestic banks. This reflects the view of the Narasimham Committee that ensuring the integrity and autonomy of public sector banks is the more relevant issue and they could improve profitability and efficiency without changing their ownership if competition were enhanced.
- An another interesting feature of India's banking sector is that the Reserve Bank of India has permitted commercial banks to engage in diverse activities such as securities related transactions, (for example underwriting , dealing and brokerage) foreign exchange transactions and leasing activities. The 1991 reforms lowered the CRR and SLR enabling banks to diversify their activities.
- The reforms have contributed to the good performance of some major banks in the country post reform period, for instance State Bank of India, Punjab National Bank, etc. This could be attributed to (a) import of better risk management skills, (b) intensified competition, (c) the diversification of business, (d) reorganization (for example, mergers and acquisitions), and (e) goodwill of the bank concerned.

Caution Due to virtual absence of an exit policy excepting the voluntary retirement scheme announced by a few banks in the year 2000, mergers and acquisitions among problematic banks have so far not occurred, which in reality is the need of the hour.

- The government's commitment on restructuring the highly regulated banking appears strong despite lack of arithmetic of the government in the parliament to push through the agenda of reforms in an effective manner. Since financial reforms were launched in 1991, post-Narasimham precisely and particularly when the entry of new banks was permitted in the year 1993, public sector banks appear to have become more conscious of the need for greater profitability and efficiency suggesting that the reform has had a favourable impact on country's financial market.
- The apex monetary authority's encouragement to enhance the appetite of the banks to do more non-traditional activities like novel schemes in the credit front.

Example: Reverse merger, advance against future lease rental has contributed to the improved profitability and cost earnings efficiency of the whole banking sector, including state owned public sector banks.

Notes

- There are almost 15 reform processes that have been floated by Reserve Bank of India. But nothing has been done in the front of closure of unviable bank branches and reduction in the number of employees to double productivity, may be due to lack of arithmetic in political front. Given that the public sector banks have scale advantages, the current approach of improving their performance without rationalizing them may not produce further benefits for Indian banking sector. On the contrary, the government should muster courage to go in for greater mergers and acquisitions which in the long run shall make the sector viable and safe.

Self Assessment

Fill in the blanks:

5. Accrual of interest for …….. recognition should be done in 90 days instead of 180 days.
6. The government's commitment on …….. the highly regulated banking appears strong despite lack of arithmetic of the government in the parliament to push through the agenda of reforms in an effective manner.
7. The government should muster courage to go in for greater …… and …… which in the long run shall make the sector viable and safe.

11.3 Liberalization of Banking Sector

In India, the banking sector has been dominated by public sector banks till recently. With the acceptance of LPG (Liberalization, Privatization, Globalization) model of development by the Congress government in the early 1990s has acted as a watershed for the Indian economy as a whole. This model supported the growth and development of the foreign capital of India.

Did u know? After the LPG model has been adopted foreign direct investment and foreign institutional investments are permitted in the form of foreign capital in nearly all the sectors of the economy.

Proportionate to this new growth, FDI has been allowed to the extent of 74% (raised from 49% to 74% in March 2004) in private banks and 20% in Public sector banks. Besides, in keeping with India's responsibility World Trade Organization, foreign banks have also been granted license to operate in India.

Thus, post-liberalization, foreign banks and private banks, increasingly gained acceptability in popular parlance and imagination, till now, rather than obscuring terms. RBI issued its regulation regime for both foreign banks and private banks. Initially, the guidelines for licensing of new banks in the private sector were issued by the RBI in January 1993 but the revised guidelines that are effective till date were issued in January 2001. As per these guidelines, initial paid up capital in private banks was upto ₹ 200 crores which is to be increased to ₹ 300 crores within three years of the commencement of business. The apex bank also issued comprehensive guidelines on governance and ownership in private sector banks. They aim at ensuring diversity in the ultimate control and ownership of banks in the private sector.

Notes

Caselet

India Steps up Bank Liberalization

India's parliament has passed a bill to liberalise banking regulations, potentially increasing foreign investment while also permitting some of the country's most celebrated business names to apply for new bank licenses.

Parliament's lower house passed the much-awaited legislation on Tuesday evening, in a further boost to the reforming efforts of Prime Minister Manmohan Singh's Government.

Many of India's most prominent companies, including the Tata group and billionaire Anil Ambani's Reliance conglomerate, have long-harboured plans to transform their financial services arms into fully fledged banks.

The legislation gives the Reserve Bank of India, the central bank, powers to issue new licenses, while also increasing foreign investment limits in Indian banks to 26 per cent from the present 10 per cent.

India's major business houses have effectively been barred from the sector since the Government of Prime Minister Indira Gandhi nationalised all privately owned banks in the late 1960s.

However, banking analysts suggest the RBI remains concerned about the potential risks of providing licenses to the various interested conglomerates, which are also thought to include the Aditya Birla group and Mahindra & Mahindra.

India's banking system has come under increasing strain this year, with a sharp rise in both non-performing assets and debt restructuring, especially from heavily indebted industrial groups, against a backdrop of the country's slowing economy.

"The road map for the likes of Tata and Birla will be long and arduous, given that RBI is likely to set out stringent qualification criteria," says Ravi Trivedy, an independent analyst and former head of banking at KPMG India.

But India's leading companies remain attracted by the prospect of further fast growth in the country's banking sector, which is set to become the world's third largest by 2025 as measured by assets, behind only China and the US, according to Boston Consulting Group.

"Despite the RBI's worries, I think they will get upwards of 20 applications, most of them from big Indian corporates who already have financial arms, although it may be a couple of years before the regulator makes a decision either way," said Mr Trivedy.

The Banking Laws (Amendment) Bill must now be debated in India's upper house of parliament, although most analysts think it has sufficient support to pass into law.

The new legislation also allows foreign institutions to hold higher stakes in Indian banks, potentially allowing others to follow the likes of Rabobank, of the Netherlands, which invested in Yes Bank, a fast-growing private bank, before unveiling plans to set up in India on its own.

"This change isn't going to make much immediate difference, because we don't yet know if RBI will change its own rules to reflect these higher foreign limits," says Shinjini Kumar, head of financial services regulation at PwC in Mumbai.

Contd...

Notes

"But in the medium term it could create interesting opportunities for future joint ventures, by bringing together the expertise of international banks with local banks' ability to reach a wide customer base," she said.

On Tuesday evening India's lower house of parliament also passed a bill which includes measures to improve corporate governance and auditing practices, and encourage corporate social responsibility.

Source:http://www.ft.com/cms/s/0/5b4f2cfc-49c2-11e2-a625-00144feab49a.html#axzz2M6DgoOL7

Before granting license to foreign branch under the provisions of Section 22 of the Banking Regulation Act, 1949, RBI may satisfy itself that the government or the law of the country in which it is incorporated does not discriminate against banks from India in any way. Foreign banks' track record of compliance and functioning in the global market may also be considered. Further, diplomatic and bilateral relations between India and the foreign country in which the bank is incorporated may also be considered.

RBI issues a single class of banking license to all banks and thereby does not place any restriction in the operations of foreign banks.

Notes Foreign banks can conduct both wholesale and retail banking.

In addition, the norms for foreign banks' capital adequacy, asset classification and income recognition vis-à-vis Indian banks are by and large similar.

11.3.1 Three Features of Liberalization

Financial liberalization has involved three major sets of initiatives in the banking sector which dominates the financial system of the country.

First, Those aimed at increasing the credit creating capacity of banks through reductions in the statutory liquidity and cash reserve ratio, while offering them greater leeway in using the resulting liquidity by drastically cutting priority sector lending targets.

The second was to increase competition through structural changes in the financial sector. While the existing nationalized banks, including the state bank of India, were permitted to sell equity to the private sector, private investors were permitted to enter the banking sector. In addition, foreign banks were given greater access to the domestic market, both as branches and subsidiaries, subject to the maintenance of a minimum assigned capital and being subject to the same rule as domestic banks.

Notes With the development of finance institutions, a degree of "broad-banding" of financial services was permitted and these institutions were allowed to set up mutual funds and commercial banks.

Banks themselves permitted to diversify their activity into a host of related areas. The wider trend is towards a form of universal banking.

Thirdly, to keep this competition effective and efficient in influencing the functioning of banks, they have been provided with greater freedom in determining their asset portfolios. They were permitted to cross the firewall that differentiated the banking sector from the stock market and invest in equities, provide advances against equity provided as collateral, and offer guarantees to the broking community.

Notes

Impact

The operations of banks have been immediately affected by all these initiatives, which in turn chose to modify their credit portfolio and diversify out of their overwhelmingly dominant role as credit-providing intermediaries. To start with, non-food credit itself was increasingly being diverted away from the priority sectors (such as agriculture and the small scale sector), industry and the wholesale trade, to other areas.

Example: Provision of loans to individuals for purchases of consumer durables and investment in housing and towards lending against real estate and commodities.

While this shift increased the interest incomes that could be garnered by the banks, it also increased their exposure to the euphemistically-termed 'sensitive' sectors, where speculation is very frequent and returns are volatile.

Secondly, several kinds of investments in securities have gained importance, in bringing a greater exposure to stock markets. This was indeed a part of the reform effort. As an RBI-SEBI joint committee on bank exposures to the stock market noted: "Globally, there is a shift in the asset portfolio of banks from credit to investments keeping in view the fact that investments are liquid and increase the earnings of banks. The committee feels that banks' participation would also promote stability and orderly growth of the capital market." The impact of this shift on scheduled commercial banks in India is visible from a rise in "investments" by banks, which is due to a significant extent to bank preference for credit substitutes.

Initially, the investments were done largely in safe securities of government and other approved securities. But over the last four years, there has been a sharp increase in investments in non-SLR securities with the share within such investments accounted for by loans to corporates against shares, investments in private bonds and in private equity, debentures and preference shares also increased over time. These trends, however, are based on aggregate and average figures that conceal the differential distribution of such exposure across different kinds of banks. Such differentials have been substantial.

Example: Bank lending to sensitive sectors such as commodities, the real estate and the capital market.

While, the sum total of such lending is still small, there are some segments of the banking sector, especially the old and new private sector banks that are characterised on average by a much higher degree of such exposure.

Task Study two term papers on liberalization of banks in India over the internet and highlight the main points via a presentation.

Self Assessment

Fill in the blanks:

8. LPG model supported the growth and development of the ……. capital of India.
9. …….. paid up capital in private banks was upto ₹ 200 crores which is to be increased to ₹ 300 crores within three years of the commencement of business.
10. Foreign banks can conduct both ……. and …….. banking.

Notes

11. With the development of finance institutions, a degree of "……..." of financial services was permitted and these institutions were allowed to set up mutual funds and commercial banks.

Case Study

Co-operative Bank Scams in India

"The objective of co-operative banking is to create enduring and sustainable financial institutions which remain responsive to the credit needs of weaker sections."

- RBI Report on Trend and Progress of Banking in India, 2000-01

"There has been a mushrooming of co-operative banks in the country. Low barriers to entry spurred individuals with vested interests to start such banking ventures with a view to milk the depositors funds."

– Suresh Hemmady, chairman of the Shamrao Vithal Co-operative Bank

"They are non co-operatives under the camouflage of co-operatives."

– Rama Reddy, President of Hyderabad based Co-operative Development Foundation

The case, "Co-operative Bank Scams in India" gives an insight into the various scams and malpractices in co-operative banks in India and their implications on the Indian financial sector. The case begins with a history of co-operative banking in India. It briefly describes the structure of co-operative banks and their characteristics. The case then discusses in brief the scams that surfaced in four co-operative banks, viz., Madhavpura Mercantile Co-operative Bank (MMCB), Krushi Co-operative Urban Bank (KCUB), Charminar Co-operative Urban Bank (CCUB) and Nagpur District Central Co-operative Bank (NDCCB) in 2001-02. The case also discusses how to revive the functioning of co-operative banks in India.

Many of these banks did not adhere to the prudential norms prescribed by the Reserve Bank of India (RBI). The Madhavapura Mercantile Co-operative Bank (MMCB) had invested a huge amount in the equity market which was almost equal to its deposit base, thus, violating the RBI norms relating to exposure to the equity market. Another bank, the Krushi Co-operative Urban Bank (KCUB) had issued loans and advances amounting to ₹ 530 million as against its deposit base of ₹ 350 million. Not only that, most of its loans had not been secured. Similarly, the Charminar Co-operative Urban Bank (CCUB) faced liquidity problems due to indiscriminate lending to big borrowers against worthless land. More recently the Nagpur District Central Co-operative Bank (NDCCB) was involved in fraudulent dealings in government securities through brokers.

Co-operative banks were established in India to facilitate rural credit, and to cater to the needs of small farmers and businessmen.

They were popular with middle and lower income groups because of the high interest rates they offered as compared to commercial banks.

However, with the passage of time, most co-operative banks lost their purpose. Excessive state control and politicisation further led to their deterioration. By the 1990s, none of the public or private sector banks were willing to deal with co-operative banks and thus even otherwise healthy co-operative banks were facing a tough time.

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Notes

In 2001-2002, many co-operative banks were rocked by scams that exposed the malpractices in these banks.

Co-operative Banks – A Profile

In the early 20th century, the availability of credit in India, more particularly in rural areas was non-existent. There was no organized institutional credit for agricultural and related activities. People in the rural areas largely depended on money lenders who lent money at very high rates of interest. Thus, there was need to create an institution which would cater to the needs of ordinary people and was based on the principles of co-operative organisation and management. In 1904, the first legislation on co-operatives was passed. In 1914, the Maclagen committee suggested a three tier structure for co-operative banking i.e. Primary Agricultural Credit Societies at the grass root level, Central Co-operative Banks at the district level and State Co-operative Banks at the State or apex level. Co-operative banks were expected to serve as substitutes for money lenders, and provide both short-term and long-term institutional credit at reasonable rates of interest.

Co-operative banks operate both in urban and non-urban centres. The urban areas are served by the Primary (Urban) Co-operative Banks (PCBs/UCBs) whereas the rural areas are largely served by two sets of institutions, the PACSs and LDBs, dispensing short-term and long-term credit, respectively. UCBs have a three-tier structure with the State Co-operative Banks (SCBs) at the apex level, the District Central Co-operative Banks (CCBs) at the intermediate level and the Primary Agricultural Credit Societies (PACS) at the grass root level. Under the long-term credit structure, State Co-operative Agriculture and Rural Development Banks (SCARDBs) are at the apex level and the Primary Co-operative Agriculture and Rural Development Banks (PCARDBs) are at the base level.

MMCB was established on October 10, 1968 in Ahmedabad, Gujarat, to cater to the varied financial needs of wholesale grocery traders in Ahmedabad's Madhavpura spice market. The bank was awarded the status of a scheduled bank in 1999, which permitted it to expand its banking activities outside Gujarat. MMCB had 22 branches and was undertaking regular banking activities. It had a deposit base of ₹ 10.56 billion in 1999-00, of which ₹ 6 billion was from other co-operative banks and organizations, while the rest was from the public.

The bank received huge deposits after being awarded the status of a scheduled bank by RBI. KCB, a Hyderabad based bank was registered on April 1, 1998. On March 31, 2000, the bank had a paid-up share capital of ₹ 10.2 million. Its deposits comprised 92.41% term deposits, 5.42% current deposits and 2.17% savings deposits.

Scams in Co-operative Banks

In 2001, MMCB was rocked by a scam. The bank had lent ₹ 10.5 billion to the equity market. There was no security or collateral issued against the money taken as a loan. This exposure was almost equivalent to its deposit base of ₹ 10.56 billion in the financial year 1999-2000.

Its advances during the year were ₹ 7.78 billion. The bank violated the RBI norms which stated that a bank's exposure to the stock market cannot exceed 5% of its outstanding loans. Panicky depositors began withdrawing money on hearing reports that the bank had lent heavily in capital markets and that these loans had turned difficult to deal with, due to a steep fall in share prices. Only three entities accounted for the 10.5 billion. No security or collateral was deposited with the bank. While ₹ 8.3 billion was lent to stock broker Ketan Parekh and his companies, ₹ 2 billion and ₹ 20 million were lent to Bombay Stock Exchange (BSE) broker, Mukesh Babu, and the Maniar group respectively.

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Notes

Reviving Co-operative Banking

Co-operative banks have for long been the back bone of rural banking. Since their inception, they have been doing excellent work in the field of rural and co-operative banking. The recent scams in co-operative banks have been a jolt to co-operative banking system. Many analysts have suggested that co-operative banks should be brought under the complete control of RBI ending the dual control by the State governments and RBI-NABARD. According to N. Patel, Vice-Chairman of Gujarat Urban co-operative Banks Federation, control by a single authority will ensure smooth governance of co-operative banks. Some analysts also feel that interference from the registrar of co-operatives should be minimized.

Question

Write down the case fact related to the scams in the urban co-operative banks.

Source: http://www.icmrindia.org/casestudies/catalogue/

11.4 Summary

- After the first nationalisation of 14 major banks on 19th July 1969, the government appointed the Saraiya Commission in 1969, to examine the banking system and recommended ways to make it efficient in working in coordination with government policies for national economic development.
- The first phase of banking sector reform which began during 1992-93 was based on twin principles of "Operational Flexibility" and "Functional autonomy".
- The Government of India constituted a Committee under the Chairmanship of Sh. M. Narasimham, former governor, Reserve Bank of India to examine the structure and functioning of the existing financial system of India and suggest suitable reforms.
- The second phase of reforms envisaged greater autonomy to priority sector banks with respect to recruitment and promotion of staff, better asset liability management, lesser external intervention and pressures etc.
- In 1998 the government appointed yet another committee under the chairmanship of Mr. Narsimham. It is better known as the Banking Sector Committee.
- While India's financial reforms have been comprehensive and in line with global trends, one unique feature is that, unlike with other planned economies, the Indian Government did not engage in a drastic privatization of public sector banks.
- An another interesting feature of India's banking sector is that the Reserve Bank Of India has permitted commercial banks to engage in diverse activities such as securities related transactions, (for example underwriting, dealing and brokerage) foreign exchange transactions and leasing activities.
- The reforms have contributed to the good performance of some major banks in the country post reform period, for instance State Bank of India, Punjab National Bank etc.
- Since financial reforms were launched in 1991, post-Narasimham precisely and particularly when the entry of new banks was permitted in the year 1993, public sector banks appear to have become more conscious of the need for greater profitability and efficiency suggesting that the reform has had a favourable impact on country's financial market.
- With the acceptance of LPG (Liberalization, Privatization, Globalization) model of development by the Congress government in the early 1990s has acted as a watershed for the Indian economy as a whole.

Notes

- Post-liberalization, foreign banks and private banks, increasingly gained acceptability in popular parlance and imagination, till now, rather than obscuring terms. RBI issued its regulation regime for both foreign banks and private banks.
- RBI issues a single class of banking license to all banks and thereby does not place any restriction in the operations of foreign banks.

11.5 Keywords

Accrual: Something that accumulates or increases.

Capital: The money, property, and other valuables which collectively represent the wealth of an individual or business.

FDI: Foreign Direct Investment.

Leeway: The amount of freedom to move or act that is available.

Liberalization: The act of making less strict.

License: A permit from an authority to own or use something, do a particular thing, or carry on a trade.

Privatization: Changing something from state to private ownership or control.

Recommendation: Something that recommends, especially a favourable statement concerning character or qualifications.

Reforms: The action or process of reforming an institution or practice.

Securities: The state of being free from danger or threat.

Subsidy: A sum of money granted to support an arts organization or other undertaking held to be in the public interest.

11.6 Review Questions

1. What do you mean by "social-control" on banks imposed by the government?
2. Explain the principles on which the first phase of banking sector reforms was based.
3. What recommendations were given by Narsimham Committee regarding SLR and CRR?
4. What did the Narsimham Committee Report said about priority sector lending?
5. What accounting policies were recommended in Narsimham Committee Report?
6. When was Narasimham Committee (ii) reappointed by government? Explain the focus areas of the committee.
7. Explain the recommendations that were given in Narasimham Committee Report (ii).
8. What do you mean by assessment of financial sector reforms?
9. Briefly explain the concept of liberalization in banking sector.
10. Explain liberalization of banks in India.
11. What is the impact of liberalization in banking sector?

Notes

Answers: Self Assessment

1. Branches
2. Expertise
3. Transparency; disclosure
4. Functional
5. Income
6. Restructuring
7. Mergers; acquisitions
8. Foreign
9. Initial
10. Wholesale; retail
11. Broad-banding

11.7 Further Readings

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Notes

Unit 12: Capital Adequacy

CONTENTS

Objectives

Introduction

12.1 Capital Adequacy in Indian Banks

12.1.1 Capital Adequacy

12.1.2 Approaches to Capital Adequacy

12.2 Basel II Norms (New Capital Adequacy Framework)

12.2.1 Minimum Capital Requirement (Pillar I)

12.3 Summary

12.4 Keywords

12.5 Review Questions

12.6 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the capital adequacy in Indian banking
- Describe several approaches to capital adequacy
- Explain Basel II norms

Introduction

In the previous unit, we dealt with the reforms brought about in the banking sector by their liberalization. The unit also discussed about the Narsimham Committee. This unit will help you to understand the meaning of capital adequacy and its various approaches. The various section and sub section of this unit will also summarize the Basel II norms and new capital adequacy framework. Regulators try to ensure that banks and other financial institutions have sufficient capital to keep them out of difficulty. This not only protects depositors, but also the wider economy, because the failure of a big bank has extensive knock-on effects. The risk of knock-on effects that have repercussions at the level of the entire financial sector is called systemic risk. Capital adequacy requirements have existed for a long time, but the two most important are those specified by the Basel committee of the Bank for International Settlements.

12.1 Capital Adequacy in Indian Banks

Economist definition of capital may differ from an accountant's definition, which in turn, can differ from the definition used by regulators. Specifically, the economic definition of a bank's capital or owner's equity stake a financial institution (FI) is the difference between the market values of its assets and its liabilities.

This is also called the net worth of an FI. While this is the economic meaning of capital, regulators have found it necessary to adopt different definitions of capital that depart by some greater or lesser degree from economic net worth. The concept of an FI's economic net worth is really a market value accounting concept.

Notes

12.1.1 Capital Adequacy

It is the test of a financial business's ability to meet its financial obligation. Capital adequacy rules mean that a bank/financial institution has to have enough money to conduct its business.

The Committee on Banking Regulations and Supervisory Practices (Basel Committee) had released the guidelines on capital measures and capital standards in July 1988, which were been accepted by Central Banks in various countries including RBI. In India, it has been implemented by RBI w.e.f. 1.4.92.

Capital Adequacy Ratio or CAR

It is ratio of capital fund to risk weighted assets expressed in percentage terms.

Objectives of Capital Adequacy Ratio (CAR)

The fundamental objective behind the norms is to strengthen the soundness and stability of the banking system.

Minimum requirements of capital fund in India:

- Existing banks 09%
- New private sector banks 10%
- Banks undertaking insurance business 10%
- Local area banks 15%

Tier I Capital should at no point of time be less than 50% of the total capital. This implies that Tier II cannot be more than 50% of the total capital.

Capital Fund

Capital Fund has two tiers – I and II

Tier I capital includes:

- paid-up capital,
- statutory reserves,
- other disclosed free reserves, and
- capital reserves representing surplus arising out of sale proceeds of assets.

Minus

- equity investments in subsidiaries,
- intangible assets, and
- losses in the current period and those brought forward from previous periods, to work out the Tier I capital.

Tier II capital consists of:

- Undisclosed reserves and cumulative perpetual preference shares,
- Revaluation reserves (at a discount of 55 percent while determining their value for inclusion in Tier II capital),
- General Provisions and Loss Reserves up to a maximum of 1.25% of weighted risk assets,
- Investment fluctuation reserve not subject to 1.25% restriction,

Notes

- Hybrid debt capital Instruments (say bonds),
- Subordinated debt (long-term unsecured loans).

Risk weighted assets (Fund based): Risk weighted assets mean fund-based assets, such as cash, loans, investments and other assets. Degrees of credit risk expressed as percentage weights have been assigned by the RBI to each such assets.

Non-funded (off-balance sheet) items: The credit risk exposure attached to off-balance sheet items has to be first calculated by multiplying the face amount of each of the off-balance sheet items by the credit conversion factor. This will then have to be again multiplied by the relevant weightage.

Reporting requirements: Banks are also required to disclose in their balance sheet the quantum of Tier I and Tier II capital fund, under disclosure norms.

An annual return has to be submitted by each bank indicating capital funds, conversion of off-balance sheet/non-funded exposures, calculation of risk-weighted assets, and calculations of capital to risk assets ratio.

The adequacy of firm's capital depends on many variables.

Example: It would be considered appropriate for a financial firm to have more capital, everything else held constant, in the following circumstances:

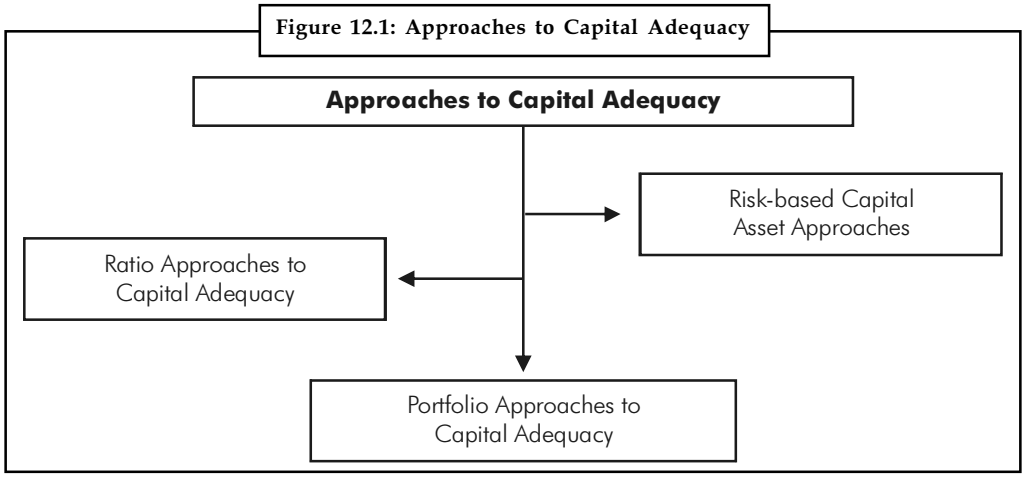
- The institution has a high percentage of risky assets.
- The institution has a large unmatched interest rate risk position.
- The institution employs a high percentage of wholesale funding sources.
- The institution lacks diversification of assets by having a high concentration of assets in a few markets.

The net worth to total assets ratio tells us about the firm's overall financial leverage relating to those assets held on the balance sheet. The higher the ratio, the lower the financial risk of the company.

12.1.2 Approaches to Capital Adequacy

The different approaches to capital adequacy in modern times:

Figure 12.1: Approaches to Capital Adequacy



Source: C. Gulati Neelam (2010),"*Principles of Banking Management*", Excel Books.

Notes

Ratio Approaches to Capital Adequacy

Ratio approaches are among the oldest methods of capital adequacy analysis and are still widely used by both managers and regulators. Ratio standards are generally expressed in terms of the ratio to total assets. Ratio standards may be developed for equity capital, primary capital or total capital.

A traditional approach to developing ratio is to use judgments in light of experience. Judgment may be supplemented by studies of past failure.

Example: We might look at the failure percentage over a number of five-year periods and study the relationship between failure clearing each five-year period and capital ratios at the beginning of that five-year period.

When regulators are developing ratio standards, they are more interested in the solvency of whole banking system than in single financial institutions. Furthermore, they want rules that are simple to explain and that provide usable standards for monitoring performance. Regulators may study past failure experience of banks to determine capital ratios that will keep failure at an acceptable level.

Risk-based Capital Asset Approaches

Proposals for risk-based capital standards have been around for years and are getting increased attention.

Notes Regulators in the United States and Great Britain worked jointly to develop a standard in 1987.

Under the proposal being developed, off balance sheet claims such as credit guarantees would also be given a weight and added to actual assets. A risk-weighted asset base would be developed in this way, and capital requirements would then be a percentage of that risk-weighted asset base.

The appeal of the risk-based approach is that it is a step forward from simply looking at total assets in terms of riskiness. The risk-based approach also has the advantage of requiring capital to support off balance sheet source of risk such, as loan guarantees.

Task Take an appointment with the branch manager of a bank and make a list of the various capital adequacy guidelines he is aware of.

Portfolio Approaches to Capital Adequacy

Portfolio approaches to capital adequacy are based on recognition of the complex set of intersections involved in a financial institution. These approaches specifically recognize the fact that two independent risky actions may be combined to create a position that is less risky than either of the independent positions.

Example: Suppose one institution specializes in commercial loans while the other specializes in consumer loans. If these two institutions merge, total risk goes down, particularly from the viewpoint of insurance age.

Notes

Self Assessment

Fill in the blanks:

1. Committee on Banking Regulations and Supervisory Practices is also known as .....
2. The Basel Committee released the guidelines on capital ..... and capital .....
3. CAR is the ratio of Capital fund to ..... weighted ratio.
4. The information provided by the net worth to total assets ratio is overall financial leverage relating to the assets held on .....

Caselet

RBI for more Tier-I Capital Adequacy than Basel III Norms

The Reserve Bank of India (RBI) on Thursday indicated it would prescribe higher capital adequacy norms than those proposed under the Basel III framework. This would help sustain the advantage of healthy financial profiles that Indian banks currently enjoy.

At the Risk and Compliance Summit on Thursday, Deepak Singhal, chief general manager, RBI, said, "A requirement of one per cent above the floor set under Basel III would not impact Indian banks. RBI would not like our banks to be seen as laggards." The central bank, in its draft guidelines issued in December, had proposed that the common equity Tier-I capital should be at least 5.5 per cent of Risk Weighted Assets (RWAs). Basel III norms prescribe minimum common equity of 4.5 per cent.

RBI has proposed Tier-I capital of at least seven per cent and said the total capital be kept at least nine per cent. It has also proposed a capital conservation buffer in the form of common equity of 2.5 per cent of RWAs.

According to RBI, Indian banks would not have a problem in adjusting to the new capital rules, both in terms of the quantum as well as the quality. Quick estimates suggest the capital adequacy of Indian banks under Basel III norms would be 11.7 per cent, compared with the required capital to risk (weighed) asset ratio of 10.5 per cent under the Basel III norms.

Singhal said many developed and emerging countries had stringent norms to maintain a higher capital base. In Sweden, banks have to maintain a Capital Adequacy Ratio (CAR) of at least 15 per cent, while in Argentina, banks can pay dividend only when the CAR is 18 per cent or more.

Rating agency ICRA said public sector banks' median capital adequacy levels declined from 13.4 per cent on March 31, 2011, to 12.1 per cent on December 31. Tier-I capital of these banks fell from 8.7 per cent to 8.3 per cent in the same period. The capital adequacy ratios of all large private banks remain comfortable. Their median capital adequacy stood at 16.3 per cent, while the Tier-I capital was 11.2 per cent in December.

Source: http://www.business-standard.com/article/finance/rbi-for-more-tier-i-capital-adequacy-than-basel-iii-norms-112030200035_1.html

Notes

12.2 Basel II Norms (New Capital Adequacy Framework)

The Basel Capital Accord is an Agreement concluded among country representatives in 1988 to develop standardized risk-based capital requirements for banks across countries. The accord was replaced with a new capital adequacy framework (Basel II), published in June 2004. The Revised Framework was updated in November 2005 followed by a comprehensive version of the framework was issued in June 2006. Basel II is based on three mutually reinforcing Pillars that allow banks and supervisors to evaluate properly the various risks that banks face. The Pillars are:

(i) Minimum capital requirements, which seek to refine the present measurement framework;

(ii) Supervisory review of an institution's capital adequacy and internal assessment process;

(iii) Market discipline through effective disclosure to encourage safe and sound banking practices.

Did u know? Basel 1 was generalization of capital regulations, while Basel 2 is tailor made to condition or rating inputs of the borrowers.

12.2.1 Minimum Capital Requirement (Pillar I)

The New Capital Adequacy Framework (NCAF) provides three distinct options each for computing capital requirement for credit risk and operational risk as under:-

Credit Risk

(a) Standardized Approach

(b) Foundation Internal Rating Based Approach

(c) Advanced Internal Rating Based Approach

Operational Risk

(a) Basic Indicator Approach

(b) Standardized Approach

(c) Advanced Measurement Approach

Caution All commercial banks (excluding Local Area Banks and Regional Rural Banks) are required to adopt Standardized Approach (SA) for Credit Risk and Basic Indicator Approach (BIA) for Operational Risk for computing Capital to Risk Weighted Asset Ratio (CRAR) so as to fall in line with the International standards and reporting to their Boards on quarterly intervals.

With the upgradation of the risk management framework and likely accrual of capital efficiency thereto envisaged under Basel II as also the emerging international trend in this regard, it was considered desirable to lay down a timeframe for migration to the advanced approaches for credit risk and operational risk and accordingly a time frame has been drawn factoring the likely lead time for creating requisite technological and the risk management infrastructure etc. Banks were also advised to migrate to the approach, of course, with suitable approval from RBI.

Notes

Self Assessment

Fill in the blanks:

5. The Basel Capital Accord was developed to .....
6. The full form of CRAR is .....
7. NCAF stands for .....
8. Basel II is based on three mutually reinforcing ……
9. The Basel Capital Accord is an ..... concluded among country representatives in 1988 to develop standardized risk-based capital requirements for banks across countries.

Case Study

ICICI Bank – Innovations in Microfinance

"ICICI Bank is one bank that has developed a very clear strategy to expand the provision of financial products and services to the poor in India as a profitable activity."

– Haruhiko Kuroda, President, Asian Development Bank

The case describes microfinance initiatives of ICICI Bank, the largest private sector bank in India. In spite of being a new entrant, ICICI Bank has been highly successful in the microfinance sector, primarily because of its innovative microfinance business models. The case discusses some of these models including Bank led & Partnership model. Other microfinance ventures of ICICI Bank are also explained in detail. The case presents how ICICI Bank has made microfinance a viable business proposition for banks.

Forays in Microfinance

Lakshmi, a 22-year-old school dropout, lived in a remote village of Tamil Nadu. Instead of getting married and starting a family like any other village girl of her age in India, she wanted to set up on her own business.

Lakshmi started an Internet kiosk in her village, offering services like e-mail, Internet chat and tips on health and education. The kiosk was partially financed by ICICI Bank and was set up in association with n-Logue Communications. Latha, a 29-year-old married woman with three children borrowed ₹ 18,000 to set up a small provision store in Kothaipalli, a small village, in the north of Andhra Pradesh. Within a year, she started earning ₹ 3,500 a month from the store. With this money, she was able to provide her children a good education at a local private school. She was a part of a self help group in Andhra Pradesh which received financial assistance from ICICI Bank. These are real-life examples to illustrate how the micro-lending initiatives of ICICI Bank affected the lives of poor women in India.

By becoming a part of self-help groups, several rural women were able to move out of poverty. Apart from financial benefits, the initiatives helped the women to develop self confidence, improve their communication skills and raise their position in society.

In India, 400 million people spread across more than six million villages are estimated to be in need of micro-financing. The organized financial sector caters to the need of about 20 million people. ICICI Bank's micro credit initiatives involved lending small amounts to

Contd...

Notes

the people below poverty line. It provided basic banking services like savings and withdrawal along with micro-investment products like mutual funds.

This provided poor people with safer avenues for saving with little volatility. ICICI Bank was also instrumental in designing new structures through which Microfinance Institutions (MFIs) and Non-governmental Organizations (NGOs) could overcome capital constraints and expand their reach.

The structures included buying the microfinance portfolios of MFIs either on a selective basis or buying the complete loans of a branch or a particular area, and also entering into partnership arrangements with MFIs. This helped in leveraging the operational strength of NGO/MFI with the financial strength of ICICI Bank. In the world's largest securitization deal, ICICI Bank purchased a portfolio of 42500 loans worth US$ 4.3 million from Share Microfin Limited in 2004.

Background Note

In March 2004, the cumulative disbursements to SHGs stood at ₹ 39 billion. According to industry experts, the demand for microfinance in India was estimated at about ₹ 300 billion. This meant there was a huge unmet gap between demand and supply.

In the past, high demand and low supply of micro-credit was blamed on the limited efforts of major Indian financial institutions to reach the poor. Banks considered small loans as a statutory obligation rather than a business opportunity. Mainstream financial institutions considered these loans as ones that were difficult to recover, unprofitable and involving high transaction costs.

These loans were perceived to carry high risk as they had high default rates; the borrowers usually did not have any viable income generating opportunities nor did they possess any collateral guarantee.

To fill the huge gap between demand and supply, an environment that was conducive for microfinance providers was required. ICICI Bank was promoted in the year 1994 as the banking division of Industrial Credit and Investment Corporation of India Limited (ICICI). ICICI was a developmental financial institution incorporated in the year 1955, as a joint initiative of Government of India, the World Bank and representatives of the Indian industry.

By the 1990s, ICICI had emerged as a diversified financial group that offered a wide range of financial products through a network of subsidiaries and affiliates. In April 2002, ICICI merged with ICICI Bank.

Bank Led Model

The bank led model was derived from the SHG-Bank linkage program of NABARD. Through this program, banks financed Self Help Groups (SHGs) which had been promoted by NGOs and government agencies.

ICICI Bank drew up aggressive plans to penetrate rural areas through its SHG program. However, rather than spending time in developing rural infrastructure of its own, in 2000, ICICI Bank announced merger of Bank of Madura (BoM), which had significant presence in the rural areas of South India, especially Tamil Nadu, with a customer base of 1.2 million and 77 branches.

Bank of Madura's SHG development program was initiated in 1995. Through this program, it had formed, trained and initiated small groups of women to undertake financial activities

Contd...

Notes

like banking, saving and lending. By 2000, it had created around 1200 SHGs across Tamil Nadu and provided credit to them.

Partnership Model

The SHG program had been fairly successful in several states of India, but the reach was limited only to those areas where the bank's branches were operational. The partnership model of ICICI Bank aimed at reaching those areas where the bank did not have any branches.

This model aimed at synergizing the comparative advantages and financial strength of the bank with social intermediation, mobilization power and infrastructure of MFIs and NGOs. Through this model, ICICI Bank could save on the initial costs of developing rural infrastructure and micro credit distribution channels and could take advantage of the expertise of these institutions in rural areas. Initially, ICICI Bank started off by lending to MFIs and NGOs in order to provide the necessary financial support to their activities. Later, ICICI Bank came up with a plan where the NGO/MFI continued to promote their microfinance schemes, while the bank met the financial requirements of the borrowers.

Other Microfinance Initiatives

As a part of microfinance initiatives in the agriculture sector, ICICI Bank developed Farmer Service Centers (FSC). An FSC was managed by an agricultural input supply company which supplied inputs like seeds and technical knowhow to the farmers.

FSCs were also managed by an extension service organization which provided inputs, credit and technology or by an NGO that provided all the services that farmers needed for their agricultural needs. Working in close association with farmers, FSCs provided them with services like advice on seeds, sowing techniques, pest control, weed control, usage and dosage of herbicides, pesticides and fertilizers and other services associated with agriculture. The FSCs also provided crop-related information and services to farmers, apart from facilitating the sale of agricultural produce. The FSCs arranged to procure the produce through agents and sold it in organized agricultural markets thus getting better realization.

The Future

ICICI Bank plans to use the services of over 100,000 agents for its various microfinance initiatives. The bank has encouraged direct sales agents to market microfinance products into rural areas.

These agents contact several borrowers, thus expanding the reach of ICICI Bank at a low cost. Taking the FSC initiative further, ICICI Bank plans to provide farmers credit from sugar companies, seed companies, dairy companies, NGOs, micro-credit institutions and food processing industries.

SIG has been involved in a project in the southern state of Tamil Nadu to find out how wireless technology can be applied in the development of low cost models of banking. Another plan to increase the reach in rural areas is to launch mobile ATM services. ICICI Bank branded trucks have started carrying ATMs through a number of villages.

Question

Provide a business model of Microfinance, and explain how to make microfinance a viable business option.

Source: http://www.icmrindia.org/casestudies/catalogue/

Notes

12.3 Summary

- Capital Adequacy is the test of a financial business's ability to meet its financial obligation. Capital adequacy rules mean that a bank/financial institution have to have enough money to conduct its business.
- The fundamental objective behind CAR is to strengthen the soundness and stability of the banking system.
- An annual return has to be submitted by each bank indicating capital funds, conversion of off-balance sheet/non-funded exposures, calculation of risk-weighted assets, and calculations of capital to risk assets ratio.
- The higher the CAR, the lower the financial risk of the company.
- The various approaches to capital adequacy are: Ratio approach, Risk-based capital asset approach and Portfolio approach.
- Ratio standards are generally expressed in terms of the ratio to total assets. Ratio standards may be developed for equity capital, primary capital or total capital.
- The appeal of the risk-based approach is that it is a step forward from simply looking at total assets in terms of riskiness. The risk-based approach also has the advantage of requiring capital to support off balance sheet source of risk such, as loan guarantees.
- Portfolio approaches to capital adequacy are based on recognition of the complex set of intersections involved in a financial institution.
- A traditional approach to developing ratio is to use judgments in light of experience. Judgment may be supplemented by studies of past failure.
- The Basel Capital Accord was replaced with a new capital adequacy framework (Basel II), published in June 2004.

12.4 Keywords

Basel Committee: an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year.

Basel accord: The principle purpose of Basel accord is to ensure an adequate level of capital in the international banking system and to create a more level playing field so that banks could no longer build business volume without adequate capital backing.

Basel II Norms: The Basel Capital Accord was replaced with a new capital adequacy framework known as Basel II and was published in June 2004.

Capital Adequacy Ratio (CAR): A measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.

Credit Risk: The risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan.

Leverage: Use borrowed capital for an investment, expecting the profits made to be greater than the interest payable.

Net Worth: It is the amount by which assets exceed liabilities. Net worth is a concept applicable to individuals and businesses as a key measure of how much an entity is worth.

Operational Risk: A form of risk that summarizes the risks a company or firm undertakes when it attempts to operate within a given field or industry.

Notes

12.5 Review Questions

1. Discuss capital adequacy in Indian Banking.
2. What is Capital Adequacy Ratio?
3. Write short note on capital fund.
4. What are the various approaches to capital adequacy? Discuss in detail.
5. Explain Basel II norms.
6. What are the minimum capital requirements in Basel II norms?
7. What are the 2 tiers of capital fund? Explain.

Answers: Self Assessment

1. Basel Committee
2. Measures; standards
3. Risk
4. Balance-Sheet
5. Standardize risk based capital requirements for banks across countries.
6. Capital to Risk weighted Asset Ratio
7. New Capital Adequacy Framework
8. Pillars
9. Agreement

12.6 Further Readings

Books

Hajols. T. N (2009), *"Money and Banking"*, Gopaljee Enterprises.

Muraleedharan, D (2009), "*Modern Banking: Theory and Practice*", PHI Learning Pvt. Ltd.

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Online links

http://www.bankingindiaupdate.com/car.htm

http://moneyterms.co.uk/capital-adequacy/

http://www.stockmarketsreview.com/news/basel_II_norms_for_indian_banks_20090312

Notes

Unit 13: Non Performing Assets

CONTENTS

Objectives

Introduction

13.1 Meaning of Non Performing Assets

13.2 Conceptual Exposition of Non-performing Assets (Advances)

13.3 Classification of NPAs

13.3.1 Standard Assets

13.3.2 Sub-standard Assets

13.3.3 Doubtful Assets

13.3.4 Loss Assets

13.4 Provisions for NPAs

13.4.1 Standard Assets

13.4.2 Sub-standard Assets

13.4.3 Doubtful Assets

13.4.4 Loss Assets

13.5 Management of NPAs

13.5.1 Originating Factors

13.5.2 Internal Factors

13.5.3 External Factors

13.5.4 Recent Trends

13.6 Suggestions to contain NPAs of Commercial Bank in India

13.7 Steps taken by the Government and the RBI on NPAs

13.7.1 One Time Settlement/Compromise Scheme

13.7.2 Lok Adalats

13.7.3 Debt Recovery Tribunals (DRTs)

13.7.4 Credit Information Bureau (India) Ltd. (CIBIL)

13.7.5 Securitization and Reconstruction of Financial Assets and Enforcement of Security in Interest (SARFAESI) Act, 2002

13.8 Summary

13.9 Keywords

13.10 Review Questions

13.11 Further Readings

Notes

Objectives

After studying this unit, you will be able to:

- Elaborate on the meaning of Non-performing Assets
- Classify NPAs
- Discuss the provisions for NPAs
- Explain the management of NPAs

Introduction

In the previous unit, we dealt with first and second generation banking sector reforms. The unit also discussed about the liberalization of banking sector. This unit will help you to classify non-performing assets. The various section and sub section of this unit will also summarize the provisions for NPA's and management of NPA's. Non Performing Assets concept was introduced by Reserve Bank of India on 1st April 1991. These are to be identified on balance sheet date only. In case government guarantee is invoked such an account is called as Non Performing Assets. In case of advances granted for agricultural purpose where interest/instalment is in arrear for more than two quarters from the date of interest/instalment being due for repayment the advances shall be treated as Non Performing Assets.

In case where there are threats of recovery on account such as frauds committed by borrowers are classified as doubtful assets and remained as Non Performing Assets. Thus an asset is classified as Non Performing Assets if due in the form of principal and interest are not paid by the borrower for a period of 180 days. However, with a view to moving toward international best practices and to ensure greater transparency it has been decided to adopt the 90 days overdue norm for identification of Non Performing Assets from the year ending March 31, 2004.

13.1 Meaning of Non Performing Assets

Non-performing assets, also known as Non-productive Assets (NPAs), constitute an integral part of banks' operations. A bank gives out money upfront and earns income overtime on the promise of a borrower to repay. When loans are not repaid, the bank loses both its income stream, as well as its capital. The level of non-performing loans is recognized as a critical indicator for assessing banks' credit risk, asset quality and efficiency in allocation of resources to productive sectors.

The most calamitous problem facing commercial banks all over the world in recent times is spiralling NPAs which are affecting their viability and solvency and thus posing challenge to their ultimate survival. NPAs adversely affect lending activity of banks as non-recovery of loan installments as also interest on the loan portfolio negates the effectiveness of credit-dispensation process. Non-recovery of loans also hurt the profitability of banks. Besides, banks with a high level of NPAs have to carry more owned funds by way of capital and create reserves and provisions and to provide cushion for the loan losses.

Did u know? The solvency crisis of financial systems, such as the American Savings and Loan crisis in the 1980s, the Nordic banking crisis at the beginning of 1990s and more recently, the banking sector problems in Japan and Turkey and of late sub-prime crisis in the US have, in large measure, been a consequence of accumulation of problem loans overtime.

Notes

NPAs, thus, make a two-pronged attack on the bottom-lines of commercial banks; one, interest applied on such assets is not taken into account because such interest is to be taken into account only on its realization unlike interest on performing assets, which is taken into account on accrual basis; two, banks have to make provisions on NPAs from out of the income earned by them on performing assets.

Persistently, high level of NPAs in loan portfolio of banks make them fragile leading ultimately to their failure. This will shake the confidence both of domestic and global investors in the banking system which will have a multiplier effect bringing disaster in the economy.

Thus, managing bad loans and keeping them at the lowest possible level has become a keyword for the banking industry in recent years.

Notes At this juncture those world-class banks do not have NPAs of over 2 percent of the total portfolio.

An NPA level of over 5 percent is an indicator of poor quality of loan portfolio.

Caution With growing competition and shrinking spreads, banks should strive to keep NPAs much below the level of 10 percent to make net earnings necessary for their survival and growth.

Thus, the most critical condition for bringing about an improvement in the profitability of banks is reduction in the level of NPAs. In fact, it is a precondition for the stability of the financial system.

Self Assessment

Fill in the blanks:

1. Non-performing Assets concept was introduced by reserve bank of India on .....
2. Non-performing assets are also known as .....
3. An NPA level of ..... is an indicator of poor quality of loan portfolio.

13.2 Conceptual Exposition of Non-performing Assets (Advances)

The RBI introduced in 1985-86 the Health Code System for commercial banks advising them to recognize income only on realization basis, initially in respect of accounts under Health Code No.6 and above, subsequently for those under Health Code No.5 too. While the Health Code classification was serving as a useful Monitoring and Management Information Mechanism, absence of a transparent, objective and uniform yardstick for measurement of problem (sticky) advances was the major drawback of this system.

Notes

Caselet

Non-performing Assets in Indian Banks

RBI has been insisting on banks to utilise various measures on recovery of bad loans and strengthen due diligence. The global rating agency, Moody's, in its latest report of 2013, has downgraded Indian banking system's rating outlook from 'stable' to 'negative'. The Reserve Bank of India (RBI) has also observed in its second quarter review of monetary policy 2012-13 that the Non-performing Assets (NPA) and restructured loans of banks have been increasing significantly and a major reason for deterioration in the asset quality of banks is the lack of effective timely information exchange among banks on credit, derivatives and unhedged foreign currency exposures. As per the available statistics, NPAs for all banks rose to 3.6 per cent in September 2012 and are expected to reach 4% by March 2013 and 4.4 per cent by the March 2014. In the first two quarters of the current fiscal 2012-13, the banks referred a record number of 74 CDR cases; total debt requiring restructuring increased to ₹ 40,000 crore. Latest quarterly results of banks show that NPAs of at least in 35 banks rose from the last fiscal 2011-12 by 28 per cent reaching over ₹ 32,000 crore in the first half of current financial year, amounting bad loans to ₹ 1.47 lakh crore as on September 30, 2012.

NPAs in SBI have grown 24 per cent marking over ₹ 49,000 crore in 2012-13, constituting one third of gross NPAs of all listed banks put together. SBI's gross NPA as percentage of total advances has risen to 5.15% from 4.4 per cent. As per the latest data available with CDR cell, 466 cases involving debt of ₹ 2.46 lakh crore have been referred to it since its inception. High interest costs, along with overall sluggishness in the domestic and global economies are reported to be the reasons for the companies to meet their debt obligations. In order to reflect true financial health of the banks in their financial reports, RBI had issued a master circular in June 2008 detailing prudential norms on NPA, asset classification, income recognition and provisioning. An asset becomes non-performing when it ceases to generate income for the bank. Keeping in line with the international best practices, NPA has been defined from March 31, 2004 as credit in respect of which interest and/or instalment of principal has remained 'overdue' for more than 90 days. Identification of NPA should be done on an ongoing basis and doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the amount would have been classified as NPA.

The central bank has advised all banks to put in place an effective mechanism for information sharing by December 2012 and instructed that fresh sanction of loans should be done only after obtaining requisite information from January 2013. In the present scenario, it has become all the more important for RBI's mandatory inspection to act as an effective deterrent for banks not to resort to non-adherence to applicable prudential norms and less provisioning for NPAs.

Source: *http://www.business-standard.com/article/opinion/kp-shashidharan-non-performing-assets-in-indian-banks-113021000913_1.html*

In order to ensure greater transparency in the borrower accounts and to reflect actual health of banks in their balance sheets, the RBI introduced prudential regulations pertaining to income recognition, asset classification and provisioning recommended by Narasimham Committee with certain modifications in a phased manner over a three-year period beginning 1992-93. These regulations have put in place objective criteria for asset classification, provisioning and recognition of income which was lacking hitherto. This change has brought in necessary quantification and objectivity into the determination of NPAs. Thus, as per the asset classification,

Notes

"An asset (advance) is considered as non-performing in case if interest or installments of principal or both remain unpaid for more than two quarters and if it has come past due, i.e., 30 days after the due date."

An advance is to be classified as 'sub-standard' if it remains NPAs up to a period of two years and will be classified as 'Doubtful' if it remains NPA for more than two years (which was reduced to 18 months from the year ending 31st March 2001). An account will be classified as 'loss' without any waiting period where the dues are considered uncollectible or only marginally collectible.

In order to move towards international best practices and impart greater transparency, it was decided by the RBI to introduce classification of loans as non-performing when interest and/or installments of principal remain overdue for a period of more than 90 days from the year ending March 31, 2004.

Self Assessment

Fill in the blanks:

4. RBI introduced in ..... the Health Code System for commercial banks.
5. An advance is to be classified as 'sub-standard' if it remains NPAs up to a period of .....

13.3 Classification of NPAs

Banks should classify their assets into the following broad groups, namely -

- Standard Assets
- Sub-standard Assets
- Doubtful Assets
- Loss Assets

13.3.1 Standard Assets

Standard Asset is one which does not reveal any problems and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.

13.3.2 Sub-standard Assets

(a) W.e.f. March 31, 2005 an asset would be classified as sub-standard if it stayed NPA for a period less than or equal to 12 months. In these cases, the current net worth of the borrowers of the current market value of the security charged is not enough to check recovery of the dues to the banks in full. Putting it differently, such assets will have well defined credit weaknesses that threaten the extermination of the debt and are characterised by the distinct possibility that the banks will suffer some loss, if deficiencies are not corrected.

(b) An asset where the terms of the loan agreement concerning interest and principal have been rescheduled after commencement of production should be classified as sub-standard and should remain in such category for at least 12 months of satisfactory performance under the rescheduled terms. In other words, the categorization of an asset should not be upgraded just as a result of rescheduling, unless there is an acceptable compliance of this condition.

Notes

13.3.3 Doubtful Assets

With effect from March 31, 2005, an asset is required to be classified as doubtful, if it has remained NPA for more than 12 months. For Tier I banks, the 12-month period of categorization of an inferior asset in doubtful category is effective from April 1, 2009. As in the case of sub-standard assets, rescheduling does not entitle the bank to promote the quality of an advance automatically. A loan classified as doubtful has all the disadvantages underlying as that classified as sub-standard, with the added feature that the disadvantages make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly doubtful and improbable.

13.3.4 Loss Assets

A loss asset is one where loss has been recognized by the bank or internal or external auditors or by the Cooperation Department or by the Reserve Bank of India review but the amount has not been written off, entirely or partly. In other terms, such an asset is considered uncollectible and of such little value that its continuation as a profitable asset is not guaranteed although there may be some relief or recovery value.

Example: We suppose a party is disbursed a loan on January 1, 2010. Its due date is June 1, 2010. But the party does not make a payment. So, it will be

- A standard asset from January 1 2010 till June 1 2010.
- Substandard from August 30, 2010 till August 29, 2011.
- Doubtful from August 30, 2011 till August 29, 2012.

Self Assessment

Fill in the blanks:

6. An asset is considered as doubtful, if it has remained NPA for more than .....
7. An account will be classified as loss where the dues are considered .....

13.4 Provisions for NPAs

Following are the provisions given by Reserve Bank of India:

In accordance with the prudential norms, provisions should be made on the non-performing assets on the basis of categorization of assets. Taking into account the time lag between an account becoming doubtful of retrieval, its recognition as such, the realization of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against standard assets, sub standard assets, doubtful assets and loss assets as below :

13.4.1 Standard Assets

(a) From the year ended March 31, 2000, the banks should make a general provision of a minimum of 0.25 per cent on standard assets.

(b) However, Tier II banks (as defined in Circular dated May 6, 2009) will be subjected to higher provisioning norms on standard assets as under:

The general provisioning necessity for all types of 'standard advances' shall be 0.40 per cent. However, direct advances to agricultural and SME sectors which are standard assets,

Notes

would attract a uniform provisioning requirement of 0.25 per cent of the funded outstanding on a portfolio basis, as hitherto.

Further, with effect from Dec 8, 2009, all UCBs (Both Tier I & Tier II) are required to make a provision of 1.00 percent in respect of advances to Commercial Real Estate Sector classified as 'standard assets'.

The standard asset provisioning requirements for all UCBs are summarized as under:

Table 13.1: Standard Asset Provisioning Requirements for all UCBs

Category of Standard Asset	Rate of Provisioning	
	Tier II	Tier I
Direct advances to Agriculture and SME sectors	0.25%	0.25%
Commercial Real Estate (CRE) sector	1.00%	1.00%
All other loans and advances not included in (a) and (b) above	0.40%	0.25%

Source: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7370#cla

(c) The provisions towards "standard assets" need not be netted from gross advances but shown separately as "Contingent Provision against Standard Assets" under "Other Funds and Reserves" (item.2) (viii) of Capital and Liabilities} in the Balance Sheet.

(d) If due to changes in the regulatory requirements on provisions to be maintained by banks, the provisions held by banks exceed what is required to be held by banks, such excess provisions should not be reversed. In future, if by applying the revised provisioning norms, any provisions are required over and above the level of provisions currently held for the standard category assets; these should be duly provided for.

(e) In case banks are already maintaining excess provision than what is required/prescribed by Statutory Auditor/RBI Inspection for impaired credits under Bad and Doubtful Debt Reserve, additional provision required for Standard Assets may be segregated from Bad and Doubtful Debt Reserve and the same may be parked under the head "Contingent Provisions against "Standard Assets" with the approval of their Board of Directors. Shortfall if any, on this account may be made good in the normal course.

(f) The above contingent provision will be eligible for inclusion in Tier II capital.

13.4.2 Sub-standard Assets

A general provision of 10 per cent on total outstanding should be made without making any allowance for DICGC/ECGC guarantee cover and securities available.

13.4.3 Doubtful Assets

Following are the provisions for doubtful assets:

(a) Provision should be for 100 per cent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse should be made and the realizable value is estimated on a realistic basis.

(b) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful:

Notes

Table 13.2: Tier I

Period for which the advance has remained in 'doubtful' category		Provision Requirements	
Up to one year		20 per cent	
One to three years		30 per cent	
More than three years (D-III)			
(i)	Outstanding stock of NPAs as on March 31, 2010	–	60 per cent with effect from March 31, 2011
		–	75 per cent with effect from March 31, 2012
		–	100 per cent with effect from March 31, 2013
(ii)	Advances classified as 'doubtful for more than three years' on or after April 1, 2010	–	100 per cent

Source: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7370#cla

Table 13.3: Tier II

Period for which the advance has remained in 'doubtful' category	Provision Requirements
Up to one year	20 per cent
One to three years	30 per cent
More than three years (D-III)	100 per cent

Source: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7370#cla

(c) The provisions towards "standard assets" need not be netted from gross advances but shown separately as "Contingent Provision against Standard Assets" under "Other Funds and Reserves" (item 2) (viii) of Capital and Liabilities} in the Balance Sheet.

(d) If due to changes in the regulatory requirements on provisions to be maintained by banks, the provisions held by banks exceed what is required to be held by banks, such excess provisions should not be reversed. In future, if by applying the revised provisioning norms, any provisions are required over and above the level of provisions currently held for the standard category assets; these should be duly provided for.

(e) In case banks are already maintaining excess provision than what is required/prescribed by Statutory Auditor/RBI Inspection for impaired credits under Bad and Doubtful Debt Reserve, additional provision required for Standard Assets may be segregated from Bad and Doubtful Debt Reserve and the same may be parked under the head "Contingent Provisions against Standard Assets" with the approval of their Board of Directors. Shortfall if any, on this account may be made good in the normal course.

(f) The above contingent provision will be eligible for inclusion in Tier II capital.

13.4.4 Loss Assets

(a) The entire assets should be written off after obtaining necessary approval from the competent authority and as per the provisions of the Cooperative Societies Act/Rules. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

Notes

(b) In respect of an asset identified as a loss asset, full provision at 100 per cent should be made if the expected salvage value of the security is negligible.

Task Go through the RBI provisions for NPA's and recommend some suggestions which you think should be made.

Self Assessment

Fill in the blanks:

8. In accordance with the prudential norms, provisions should be made on the non-performing assets on the basis of .....
9. The general provisioning necessity for all types of 'standard advances' shall be .....
10. In case of a loss asset, full provision at ..... per cent should be made if the expected salvage value of the security is negligible.

13.5 Management of NPAs

Non-performing assets came into Indian financial systems consequent to introduction of Prudential Accounting Norms. An era of taking profits (even unrealized) was changed to providing for expected loss. Days of 'counting the chickens before the eggs hatch' came to an end. However, non-performing loans did exist even before the introduction of present prudential norms. According to the RBI study, the proportion of problem loans (sticky loans) of PSUs to their gross advances stood at 17.91 percent as on March 31, 1989. This soared to 23.5 percent as on March 31, 1994. Reasons for the high level of NPAs are given below:

13.5.1 Originating Factors

According to RBI study, dues to the banking sector are generally related to the performance of the unit/industrial segment. In a few cases, the cause of NPA has been due to internal factors of the banks such as weak appraisal or follow-up loans but more often than not, it is due to factors such as management inefficiency of borrowed units, obsolescence, lack of demand, non-availability of inputs, environmental factors, etc. Wherever the unit/segment is doing well the credit relationship is generally maintained except in cases of wilful default/misappropriation/ diversion of funds. The problems to the unit/segment arising out of various internal/external factors were felt to be originating point for NPAs in banks.

13.5.2 Internal Factors

Among the internal factors responsible for high level of NPAs in Indian commercial banks, the most important ones have been project appraisal deficiencies regarding technical feasibility, economic viability and project management deficiencies in regard to implementation, production, labour, and marketing, financial and administrative matters.

The culture of Indian banking system in respect of permitting excess or irregular drawings to some extent even during the processing stage has also contributed to poor quality of loans and NPAs. Further, PSBs have had the culture of consuming longer time even more than a year in appraising loan proposals. As per the new norms if interest is not paid for two quarters, the advance is classified as NPA. If proposal for genuine enhancement remains pending for more

Notes

than six months and the borrower has already gone ahead with implementing his projected plan, the account becomes irregular for more than six months even if higher credit assistance deserved on merits.

There has been large number of cases of camouflaging irregularities by routinely rescheduling repayment or granting ad hoc facilities so as to avoid slippage of loans accounts into NPAs. Since this practice of ever greening cannot be continued indefinitely, loan accounts partook the character of NPAs.

Weak credit appraisal, non-compliance to lending norms and wilful default as also ineffective credit monitoring and follow-up mechanism of the commercial banks have also contributed to slippage of standard loans into bad loans. In India, greater focus is made on enhanced recovery of NPAs, which may be effective to contain NPAs in the short run, but very little efforts are made to follow-up once the loan is sanctioned. No serious efforts are made to study loan portfolio on multiple dimensions to monitor the aggregate exposure of the bank to industries, groups, regions, rating, classes, etc. As a result, the bank lacks any direct which can be pursued at an individual loan level. Further, collection machinery has been found lax in most of the banks in India.

Diversion of funds mostly for expansion/diversification/modernization, and taking up new projects and for helping/promoting associated concerns have been reported to be the single most prominent reasons for high level of NPAs.

Caselet

RBI asks Banks to Improve Management of Non-performing Assets

The Reserve Bank on March 29, 2012 has asked banks to improve their ability to manage stressed assets, but said there was nothing alarming about an unexpected rise in the non-performing assets (NPA) levels this fiscal. "Concerns (on NPA) are there. Banks have to improve their ability to manage NPAs. We have told banks what is their lacuna. They have to improve their information system. But we see that the situation is not alarming. Though this is our concern. Hope banks will be able to manage them," deputy governor KC Chakrabarty told reporters on the sidelines of a function organised by YES Bank. It can be noted that following the continued slowdown in economic activities on the back of rising interest rate regime, banks, especially the state-run ones, have been reporting higher NPAs in their books since the second quarter. The country's largest lender SBI had reported record gross NPAs in Q3 at ₹ 40,080 crore and saw an 87.5 per cent spike in its provisioning. But private lenders are better off. The total NPAs in the system are set to top 3 per cent of the total assets this fiscal, against a 2.3 per cent last fiscal at ₹ 98,000 crore. But what's worrying the regulator is the an over 300 per cent spike in corporate debt recast this fiscal, which has already touched ₹ 76,251, against ₹ 25054 crore in the previous fiscal. This makes the overall CDR asset in the system to over ₹ 1.9 lakh crore.

Source: http://profit.ndtv.com/news/corporates/article-rbi-asks-banks-to-improve-management-of-non-performing-assets-300813

The wide prevalent practice among commercial banks in India of providing working capital facility subject to annual renewal with or without enhancement has also been responsible for persistently high level of NPAs. If an existing company, which was performing well in the past, turns sick due to its inability to face competition or due to the changing economic and policy environment or sometimes due to inefficient management, there is no scope for the bank to withdraw the facility unless the promoters decide to close down the company to merge it with

Notes

some healthy unit. The bank finds it difficult to lay hands on the security against which working capital facility was given because of inadequate legal measures.

Table 13.4: Non-performing Assets as percentage of Advances in different Categories of Banks

Bank Groups Years	Gross NPAs	Gross NPAs as % to Gross Advances	Net NPAs	Net NPAs as % to Net Advances
Scheduled Commercial Banks				
1997	473.00	15.7	22,340	8.1
2000	60,841	12.8	30,152	6.8
2001	63,883	11.4	32,468	6.2
2005	58,300	5.2	21,441	2.0
2006	51,815	3.5	18,529	1.2
2007	50,486	2.5	20,101	1.0
2008	56,435	2.3	24,733	1.0
2009	68,973	2.3	31,424	1.1
Public Sector Banks				
1997	43,577	17.8	20,285	9.2
2000	53,294	14.0	26,188	7.4
2001	54,773	12.4	27,969	6.7
2005	47,325	6.0	16,642	2.7
2006	42,106	3.7	14,560	1.3
2007	38,968	2.7	15,145	1.1
2008	40,595	2.2	17,836	1.0
2009	45,156	2.0	21,033	0.9
Old Private Sector Banks				
1997	2,325	10.7	1,385	6.6
2000	3,986	11.3	2,484	7.3
2001	4,420	11.1	2,770	7.3
2005	4,206	6.0	1,859	2.7
2006	3,740	4.6	1,367	1.6
2007	2,969	3.1	891	1.0
2008	2,557	2.3	740	0.7
2009	3,072	2.3	1,165	0.9
New Private Sector Banks				
1997	2.7	2.6	154	2.0
2000	946	4.2	636	2.3
2001	1,617	5.1	929	3.1
2005	4,576	3.6	2,295	1.7
2006	4,336	1.8	1,793	0.8
2007	6,287	1.9	3,137	1.0
2008	10,426	2.5	4,906	1.2
2009	13,911	3.1	6,253	1.4
Foreign Banks in India				
1997	1,181	4.3	516	1.9
2000	2,616	7.0	844	2.4
2001	3,106	6.8	785	1.8
2005	2,192	2.9	648	1.9
2006	1,928	1.9	807	0.8
2007	2,233	1.8	913	0.9
2008	2,664	1.8	1,250	1.2
2009	6,833	4.0	2,973	1.8

Source: Reports on Trend and Progress of Banking in India, RBI.

Notes

13.5.3 External Factors

An important reason for the bulging of NPAs was the 'euphoria' generated following liberalization, a dream of globalization leading to huge investments, which unfortunately could not be utilized due to hesitant liberalization policies. Dominance of traditional industries in credit portfolios, industrial sickness, labour problems, the overall economic slowdown—global as well as domestic—particularly in the industrial sector have until recently adversely affected the bottom line of borrower units and their capacity to service the debt leading to slippage of standard asset into NPA.

Among other external factors, the RBI study noted that non-availability of raw materials, power shortage, transport bottlenecks, financial bottlenecks, changes in government policy, natural calamities, industrial sickness, increase in import costs, increase in overhead costs, market saturation, product obsolescence, fall in demand and others were responsible for weak performance in 48 percent of units assisted by the banks resulting into advances given to them turning bad.

An ineffective legal system is the most important factor contributing to enormously high level of NPAs in Indian commercial banks. Antiquated defaulter friendly legal system, extremely slow judicial system, and dismal record of enforcement machineries have also contributed significantly to high level of NPAs in India.

Commenting on the current legal system of the country, FITCHIBCA, an international rating agency, observed that "The Indian legal system is sympathetic towards the borrowers and works against the banks' interest. Despite most of their loans being backed by security, banks are unable to enforce their claims on the collateral when the loans turn non-performing and therefore, loans recoveries have been insignificant". The Pannir Selvam Committee of the IBA on NPAs clearly brought out that it takes decades for courts to decide cases and even after decrees are obtained execution of decrees is virtually an impossible task. Languishing of thousands of cases in courts for decades is sad reflection of the speed of recoveries through the filing of suits.

An RBI study on effectiveness of suit filing and recovery measures in the prescribed procedure for recovery of debts due to banks reveals that has resulted in blocking significant portion of their funds in unproductive assets, the value of which deteriorated with the passage of time. The multiple litigation opportunities available to the borrower units delaying the verdicts/ enforcement, courts being burdened, as they are, with heavy work coupled with tardy decision-making process in the banks, have rendered legal process less useful.

Pending of significantly large number of suits speaks volumes about the recoveries made through the suit filing. In some cases, suits were pending for 15 to 20 years, but no progress was made in the suit. Out of all the suits filed cases of ₹ 1 crore and above studied by the RBI in 15 banks, there was only one case in which the suit filing was taken to the logical end.

As at June end 1998, the PSBs had as much as 5.12 lakh suits involving an amount of about ₹ 12, 000 crores pending before the courts. As regards the time taken for disposal of suits filed by the banks, RBI study reveals that it took many years, in many cases more than a decade, for the courts to settle the suits. Even after passing of court order, due to the multiple litigation opportunities, long-time is taken for settlement of the cases.

The legal process gets further elongated /complex in cases where legal actions are either delayed or the matter comes under the purview of the Board for Industrial and Financial Reconstruction (BIFR) and the Appellate Authority for Industrial and Financial Reconstruction (AAIFR). BIFR generally takes a very long time to decide the case and approve rehabilitation package in case of sick units.

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It is also interesting to note the RBI study that Debt Recovery Tribunals (DRT) has not been effective. In fact, it has failed to achieve the declared objective of disposal of cases within six months in speedy recovery of advances. As at the end June 1997, out of total number of 11,700 cases filed and transferred to DRTs involving ₹ 8866.67 crores, only 1,045 cases had been decided and a meagre amount of ₹ 178.08 crores were pending before DRTs as on June 30, 1999.

In the present Indian work culture, finding rules, regulations and interpretation of rules to delay action or deny sanction have become very common. There are a number of cases of wrong claims of government agencies or references to courts by filing legal action with the objective of getting direction of courts rather than making-decision. This has led to growth of NPAs in the banks' loan portfolio.

The long drawn legal process not only encourages the incidence of NPAs but also prolongs their existence by placing a premium on default.

It is important to realize the havoc wrecked by the perennial and wilful defaulters on the financial system. Their acts have raised the cost of credit made bankers more risk averse and squeezed decent small and medium enterprise from accessing competitive credit. They have debased the banking system and, in the process, penalized the good borrowers. They need to be taken to task.

In view of its highly efficient legal system and regulatory framework, banks in Singapore have been rated as having the lowest risk banks among banks of Asian countries.

13.5.4 Recent Trends

In recent years, particularly after economic reforms, there was decline in proportion of gross NPAs to gross advances as also of net NPAs to net advances of all the Scheduled commercial banks. Thus, it may be glanced from Table that although both gross NPAs and net NPAs in absolute terms surged during 1997-2009, these increases have been at lower rate in correspondence with gross and net advances leading to fall in their respective share from 15.7 percent to 2.3 percent and from 8.1 percent to 1.1 percent respectively showing remarkable improvement in the asset quality of the banks. This seems to be the result of several policy measures taken by the Reserve Bank in conjunction with the government to contain the NPAs of banks. In fact, the enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and other steps taken by the government and the RBI provided a significant impetus to banks to ensure sustained recovery and a menu of options to reduce level of NPAs. An improved industrial climate also contributed to this state-of-affairs.

Group-wise analysis of NPAs reveals that in case of public sector banks, NPAs as percentage of gross advances declined significantly from 17.7 percent in 1997 to 2.0 percent in 2009. Likewise, net NPAs to net advances decreased from 9.2 percent to 0.9 percent during the corresponding years. This is due to persistent recovery set up coupled with close monitoring of the advances. Perceptible decline in the ratio of gross NPAs and net NPAs measured as percentage to advances was noticeable in case of the old private sector banks.

As regards the new private sector banks, it may be noted from the table that these banks had relatively lower NPAs during the initial years of operations. But as the banks expanded their operations, quality of their advances deteriorated. Thus, in 1997, gross NPAs of new private banks to their advanced stood at 2.6 percent, the lowest among all categories of banks. However, it tended to rise remarkably in the subsequent years to reach an all time high level of 8.9 percent in 2002, reflecting increase in defaulters. Substantial progress was, however, witnessed during the last three years, as is reflected in the steep fall in the ratio of NPAs to advances from 8.9 percent in 2002 to 1.4 percent during 2008, showing aggressive efforts made to monitor the advances and recover the same.

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Foreign banks operating in India do not seem to be as serious in sanctioning and monitoring advances in the past as they are today. As a result, gross NPAs of these banks to their total advances initially shot up from 4.3 percent in 1997 to 7.0 percent in 2000. But the same tended to decline persistently to touch an all time low level of 1.8 percent in 2009.

Among bank groups, the new private sector banks have the lowest NPAs followed by foreign banks in India, old private banks and public sector banks.

Self Assessment

Fill in the blanks:

11. As per the new norms if interest is not paid for ....., the advance is classified as NPA.
12. ..... is the most important factor contributing to enormously high level of NPAs in Indian commercial banks.
13. NPAs declined from ..... in 1997 to ..... in 2009.

13.6 Suggestions to contain NPAs of Commercial Bank in India

It is generally argued that in view of lower percentage of advances to GDP and lower economic cost of bad loans as compared to those in Tiger economies, the impact of NPAs on the Indian economy is not that alarming as witnessed recently in the East African Region, Japan or another part of the globe, viz., Russia facing chaos. This should, however, not lull the bankers and the RBI into sense of complacency because of growing competitiveness in the financial sector consequent upon globalization of Indian economy.

The mere fact that even the reduced level of NPAs of the Indian banks is still higher as compared to developed county standards of around 2 percent warrants continued remedial actions. As such, strategic measures both at micro and macro levels—along the following lines have to be taken to effectively contain the magnitude of NPAs in the loan portfolio of the banks.

The approach to NPA management by the banks has to be multi-pronged, necessitating varied strategies suited to different stages of the passage of credit facility.

In order to reduce the level of NPAs in the loan portfolio, every commercial bank has to embark upon strategic plan to prevent the occurrence of the NPAs and stoppage of health accounts into bad loans. This calls for crystal clear policy guidelines in respect of credit appraisal and monitoring on the one hand, streamlining credit assessment and supervision procedures and strengthening and the appraisal and monitoring cell, on the other.

The existing credit evaluation process is not adequate and focused and the staffs handling the job are not endowed with required skills and expertise. It is, therefore, imperative to bring about radical change in credit evaluation process to ensure any in-depth appraisal focussed on risks inherent in the proposal and to lead to a credit rating of the potential borrower. Based on financial statements and their in-depth appraisal and physical checking of stocks the bank should develop suitable model to assess health and repaying capacity of the credit applicants.

Serious attention needs to be paid to monitoring of the loans sanctioned by the bank. Since most bad loans have been due to poor credit monitoring than to poor credit appraisal, comprehensive preventive monitoring mechanism to maintain sound and health loan portfolio has to be developed. This mechanism has to lay emphasis on early detection of all signals relating to the health of the borrower, perspicacious analysis of those signals to take a view on the borrower's business and fast initiation of action upon warning signals to contain damage. Based on the

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information pertaining to financial performance of the borrowers, industry scenario, competitive position and management charges, a bank can obtain invaluable information regarding the health of the borrowers, and early warning signals regarding a borrowing party. The loan review mechanism is to be adopted as a tool to bring about improvements in credit administration. Banks should also adopt their own risk-rating systems to assess the risk of lending. Sanctions above certain limits should be through a committee, which can assume the status of an "Approval Grid". Exchange of credit information among banks would be of immense help to avoid possible NPAs.

While developing suitable policy guidelines, the focus has to be on measures to be taken at the branch level so as to identify danger signals, to diagnose the maladies and to take corrective steps in potential NPA accounts in consultation with the controlling authority. Development of IT system at branch level to capture the danger signals followed by probe to ascertain the reasons behind its occurrence and taking quick action will go a long way in staying off the incipient sickness.

Whatever be the monitoring system developed by the bank, its thrust should be on prompt action. Introducing a credit rating of borrowers on the basis of all the available relevant information will be extremely useful. Rating index acts as a trigger for a hierarchy of predetermined actions. At the early stages of account irregularity, credit officers should check loan convenient maintenance but at the other end, when the company rating starts to slip, banks should be willing to call in loans.

In order to improve quality of the existing loan portfolio and maintain it on sustaining basis, the banks management should take a long-term view of each component in the portfolio and take decisions to exclude or include some components with specific features. Taking early decisions to reduce exposure to a sector or industry and making focussed marketing efforts to bring specific type of customers in the portfolio will help the banks in keeping the portfolio in a healthy state.

The banking system ought to be so geared that a defaulter at one place is recognized as a defaulter by the system. The system will have to provide a mechanism to ensure that the unscrupulous borrowers are unable to play on bank against the other.

There is also a need to bring about change in the approach of banks towards legal action which is generally the last step. No sooner the account becomes bad, the bank should take immediate action to recover the loan.

With a view to ensuring effective and personalized appraisal, monitoring speedy recovery of dues and maintenance of robust portfolio, the existing structure needs to be revamped to make lean, flat and responsive, equipped with employees possessing right kind of skills, experiences and aptitudes. These employees with clearly defined responsibilities should be empowered in its true sense to discharge their duties properly. Accountability of the employees with respect to credit appraisal, monitoring of loan accounts and recovery of dues should be fixed and communicated to them.

Banks should also conduct special audits on a continuous basis to foil attempts of borrowers doctoring their accounts to show negative net worth and seek registration with BIFR so as to avoid/delay legal action initiated/to be initiated against them by the bank.

In view of ineffective and tortuous legal and judicial system and vitiated socio-political and ethical cultures, it would be in fitness of things to accord greater weightage to compromises as method of settlement of overdue accounts lying in the courts of law. In fact, compromises enable bankers to make better recoveries than those through court. The value of such amounts, if adjusted by the method of time-value of money, the losses incurred from the date of possible

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compromise can be worked out. Freedom to sue discretion for compromises and encouragement to it would go a long way in containing NPAs and nipping in the bud the potential court cases.

It is because of these reasons that the RBI has recently come out with a one-time measure—Settlement Advisory Committees (SACs)—to promote compromise settlement in small sector. However, unless there is an appreciation of the fact that compromise settlement is an effective and accepted non-legal remedy for recovery in chronic NPA accounts, the scheme is not likely to make much headway. The success of the schemes, as such, depends on the banker's perception about compromise settlements. There is a need to impart necessary knowledge with a view to sharpening negotiating skills and reorienting attitudes of the employees.

The above internal arrangements will have to be supported externally by a proper legal framework where under quick action against a defaulting borrower could be taken. Though there are problems in affecting recoveries and write offs, it is of utmost importance that necessary changes are brought about in the related legislations for making recovery process more smooth and less time consuming.

DRATs, as stated earlier, have so far failed to achieve their stipulated objective of expeditious disposal of cases because of several factors. Apart from setting up more DRTs and Debt Recovery Appellate Tribunals (DRATs) and equipping them with proper and adequate infrastructure and manpower support, there is a need to empower DRTs with a view to preventing the defaulters from stripping away the assets/securities during the pendency of cases. Suitable amendments in the Act/Rules should be made at the earliest.

For expeditious disposal of cases, DRTs should categorize borrowers on the basis of SWOT analysis into chronic wilful defaulters with securities/assets, non-wilful defaulters with securities/assets and defaulter without securities and prioritize them for action purpose.

In a landmark judgement pronounced on May 18, 2006, the Supreme Court of India observed that despite writing off, the debt is still recoverable by the bank. It is not true either in fact or in law that bad debts, which are written off cannot be recovered. The case relates to the Development and Credit Bank Ltd. (DCBL) deciding to write off from the financial records, debts that had turned into NPA over the years amounting to ` 120 crore. DCBL's Board of Directors and the principal shareholders of the Bank in France approved this decision and the RBI approved this decision in March, 2003. However, the decision was challenged by one of the shareholders and hence the Supreme Court verdict.

Self Assessment

Fill in the blanks:

14. The loan review mechanism is to be adopted as a tool to bring about improvements in .....
15. ..... among banks would be of immense help to avoid possible NPAs.
16. ..... acts as a trigger for a hierarchy of predetermined actions

13.7 Steps taken by the Government and the RBI on NPAs

From the regulator's perspective, there are four steps to the management of NPAs, viz; assessment, provisioning, recovery and prevention of fresh NPAs. The recent initiatives in management of NPAs are related in greater measure to the third and fourth aspects, viz; recovery and prevention aspects although norms relating to the first and second aspects have been progressively tightened to bring them at par with international best practices. Major steps taken in recent years by the Government/RBI to contain NPAs are:

Notes

13.7.1 One Time Settlement/Compromise Scheme

In May 1999, the RBI issued guidelines for the constitution of Settlement Advisory Committees (SACs) for compromise settlements of chronic NPAs of the small sector. Modified guidelines were issued in July, 2000 to provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of the stock of NPAs.

Under one-time settlement/compromise scheme of the RBI extended in May 2003, the time limit for processing of applications received under the revised guidelines for compromise and settlement of chronic NPAs of PSBs up to ₹ 10 crore up to December 31, 2003, which was further extended July 31, 2004. Amount of ₹ 1497 crore was received through 21,311 compromise proposals up to March 2005.

13.7.2 Lok Adalats

Lok Adalats have proved an effective institution for settlement of dues in respect of smaller loans. These Adalats have been conferred a judicial status. The RBI issued guidelines to banks in 2001 indicating that:

1. Ceiling of amount for coverage under Lok Adalats would be ₹ 5 lakh;
2. The scheme may include both sent-filed and non-sent filed accounts in the doubtful and loss category; and
3. The settlement formula must be flexible.

Furthermore, DRTs have been empowered to organize Lok Adalats to decide on cases of NPAs of ₹ 10 lakh and above.

The monetary ceiling of cases to be referred to Lok Adalats organized by civil courts was enhanced to ₹ 20 lakh. Furthermore, banks were advised to participate in the Lok Adalats convened by various DRTs/DRATs for resolving cases involving ₹ 10 lakh and above to reduce the stock of NPAs.

As on March 31, 2009, the number of cases filed by commercial banks with Lok Adalats stood at 5, 48,308 involving ₹ 11763 crore. The number of cases decided was 4, 04,378. The amount recovered was ₹ 2105 crore.

13.7.3 Debt Recovery Tribunals (DRTs)

The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993 to provide for the establishment of tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions and for matters connected therewith and incidental thereto. The amendments made in 2000 to this Act and the Rules framed there under further strengthened the functioning of DRTs.

Up to March 31, 2009, 81,173 cases involving ₹ 1, 30,917 crore had been filed with DRTs by the banks. 45,088 cases involving ₹ 62, 849 were adjudicated with the amount recovered at ₹ 24, 884 crore.

On the recommendation of the Reserve Bank, the Government of India set up a working group in July, 2004 to improve the functioning of DRTs. The working group was expected to examine issues and recommend appropriate measures regarding: (a) the need to extend the provisions of the Recovery of Debts Due to Banks and Financial Institutions Act to cases for less than ₹ 10 lakh; (b) redistribution of the Jurisdiction of the various DRTs; (c) modification in the existing strength of the DRTs/Debt Recovery Appellate Tribunals (DRATs); and (d) Legal and Institutional provisions.

Notes

13.7.4 Credit Information Bureau (India) Ltd. (CIBIL)

Taking cognizance of the utility of an effective institutional mechanism for sharing of information on borrowers/potential borrowers by banks, CIBIL was set up in 2001. Banks were advised to go for parallel reporting of data on suit filed accounts to both the RBI and CIBIL up to March 31, 2003 and switch over such reporting to the CIBIL effective from April 1, 2003.

Banks have been urged to make persistent efforts in obtaining consent from all their borrowers in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery. Further, with a view to strengthening the legal mechanism and facilitating credit information on borrowers of bank/FIs, a draft credit information companies Regulation Bill, 2004 covering registration, responsibilities of the bureaus, rights and obligations of the credit institutions and safeguarding of privacy rights is under active consideration of the government.

13.7.5 Securitization and Reconstruction of Financial Assets and Enforcement of Security in Interest (SARFAESI) Act, 2002

Until the enactment of Securitization Act, Banks/financial institutions had to enforce their security through court which was a very slow and time consuming process. There was also no provision in any of the present law in respect of hypothecation, though hypothecation is one of the major security interest taken by the Bank/financial institution. The Securitization Act was first enacted with effect from 21-06-2002 to overcome the hardships faced by the Banking industry.

The salient features of the Securitization Act are:

1. In case of any borrower having defaulted in repayment of secured debt or any instalment thereof and his account in respect of such debt is classified by the secured creditor as non-performing asset, then the secured creditor may require the borrower to discharge his liabilities within sixty days from the date of notice, failing which the secured creditor shall be entitled to take recourse to one or more of the following measures to recover his secured debt:

   (i) Take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured assets;

   (ii) Take over the management of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale and realize the secured asset;

   (iii) Appoint any person (hereafter referred to as the manager) to manage the secured assets the possession of which has been taken over by the secured creditor.

2. In the case of financing of a financial asset by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any of the above powers unless exercise of such right is agreed upon by the secured creditors representing not less than three-fourth in value of the amount outstanding as on a record date and such action shall be binding on all the secured creditors.

3. No borrower shall, after receipt of the notice, transfer by way of sale, lease or otherwise any of his secured assets referred to in the notice.

4. Where the possession of any secured asset is required to be taken by the secured creditor or if any of the secured asset is required to be sold or transfer by the secured creditor under the provisions of this Act, the secured creditor may, for the purpose of taking possession or control of any such secured asset, request in writing the Chief Metropolitan Magistrate

Notes

or the District Magistrate within whose jurisdiction any such secured assets or other documents relating thereto may be situated or found, to take possession thereof and the Chief Metropolitan Magistrate or as the case may be, the District Magistrate shall, on such request being made to him:

(i) take possession of such asset and documents relating thereto;

(ii) forward such asset and documents to the secured creditor; and

(iii) no act of the Chief Metropolitan Magistrate or the District Magistrate done in this respect shall be called in question in any court or before any authority.

5. Any person (including borrower), aggrieved by any of the measures as referred to above taken by the secured creditor or his authorized officer, may prefer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty five days from the date on which such measures had been taken.

6. Where an appeal is preferred by a borrower, such appeal shall not be entertained by the Debts Recovery Tribunal, unless he deposits 75 percent of the amount claimed in the notice, as referred to above. However, the Debts Recovery Tribunal may, for reasons to be recorded in writing, waive or reduce the amount to be deposited.

Self Assessment

Fill in the blank:

17. ..... is one of the major security interest taken by the Bank/financial institution.

Case Study

The Impact of Non-performing Assets on Profitability of State Bank of India

The country's largest commercial bank is the State Bank of India. The bank has a network of 52 overseas offices spread over 31 countries covering all the time zone and has correspondent relationship with 720 foreign banks. The bank recently incorporated a subsidiary State Bank of India Life Insurance Company Ltd (SBI Life) for its foray in to the Insurance business. Expansion was the main theme for banks and not consideration, which continued till the early nineties and as far as project financing is concerned, big financial institutions like IFCI, ICICI, and IDBI were the major players for the corporate world.

Assessment of Non-Performing Asset through Ratios

The following ratios were calculated to assess the effect of non-performing assets on the financial operations of the selected banks:

1. Ratio of net non-performing assets to net advances and the ratio of gross non-performing assets to gross advances
2. Ratio of operating expenditure to total income
3. Ratio of net profit to total assets
4. Ratio of net non-performing assets to total assets.

Contd...

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Non-performing asset management is one of the major areas of focus and the bank is making all efforts to bring down the net non-performing assets ratio to fewer than 3% in to 3 years time. A close monitoring the non-performing assets accounts, aggressive policy for recovery, compromise and settlement has yielded good results.

In India, the regulation traditionally has been very strict and in the opinion of certain quarters, responsible for the present condition of bank, where non-performing assets are of high order. The multiplicity of policy and regulations that a bank has to work, which makes its operations even more complicated, sometimes illogical. Banks are supposed to play an important role in achieving the objective of economic institutional credit support to various regions and sectors. Due to heavy competition in the banking industry, particularly among the Public sector banks, the SBI and its Associates have to concentrate much on the development of resources and to accelerate the collection mechanism to make it viable to strengthen profitability and efficiency in a better way.

It is important to take stock of special feature of the banking sector in India. Table-1 presents sector-wise analysis of non-performing assets.

Table 1: The Non-performing Assets of Commercial Banks Sector-wise March 2008

(as Percentage to total Non-performing Assets)

Banks	Agriculture	Small-Scale Sector	Others	Public Sector	Non-priority Sector	Total NPA (₹ in Crores)
Public Sector	20.80	14.60	28.22	0.75	35.63	39748.51
Private Sector	11.30	5.02	10.02	-	73.66	12976.06
Old Private	9.48	14.03	28.83	-	47.66	2557.15
Foreign	-	2.10	10.80	-	87.1	3114
Total						58395.72
SBI Group	21.82	10.08	26.58	0.63	40.88	15220.39
					SBG/Total	0.26
					SBG/PSB	0.38

Source: rbi.org

Table 1 shows as far as the Public Sector Banks are concerned, about 63.62% of Non-Performing Assets belong to the Priority Sector lending where as in the case of Private Sector Banks 73.66% belongs to Non-Priority Sector and Foreign Banks show 47.66% in Non-Priority Sector. This pointed out Public Sector focus majority on Priority Sector. In the case of State Bank of India 58.49% of Non-performing Assets belongs to Non Priority Sector. State Bank Group consists more than one-third of Public Sector Banks.

Table 2: The Trend of Gross Non-performing Assets in Commercial Banks as on 31st March 2008

(as Percentage of Total Assets)

Banks	GNPAs/Total Assets	
Public Sector	–21.99	–24.03
Private Sector	–13.24	–13.82
Foreign Banks	–13.28	–14.21
SBI Group	–19.37	–22.78

Source: rbi.org

Contd...

Notes

Table 3: The Trend of Net Non-performing Assets in Commercial Banks as on 31st March 2008

(as Percentage of Total Assets)

Banks	Net NPAs/Total Assets	
Public Sector	LGR	CGR
	–22.31	–25.28
Private Sector	–17.63	–18.81
Foreign Banks	2.31	–12.23
SBI Group	–17.68	–21.87

Source: rbi.org

Table 3 indicates that Net Non-Performing Assets decline is highest in the case of Public Sector Banks as compared to Private Sector Banks followed by State Bank of India Group. This further reveals that SBI group has performed even than public sector banks but better than private sector banks and foreign banks in NPA management.

Table 4: The Advances by Commercial Banks (Rupees in crores)

(as on March 31st during 1999-2008)

Banks	LGR	CGR
Public Sector	21.20	18.69
Private Sector	22.46	11.90
Foreign	17.99	15.73
Total	19.51	16.68
SBI Group	19.69	17.34

Source: rbi.org

Table 4 shows the growth of advances by different Commercial Banks in India during 1999-2008. During the last years the, advances by public sector and private sector banks have increased by about three times in comparison to the advances in 1999. Thus, from the analysis it can be concluded that in terms of Advances by Commercial Banks, the highest growth has been recorded by the private sector banks as (22.46) and the lowest growth in foreign banks (17.99). The growth of advances in SBI group is (19.69) which are slightly higher than foreign banks (17.99) but slightly lower than public sector (21.20) and private sector banks (22.46).

Table 5: Trend of Ratios of Non-performing Assets of State Bank India and its Associates

Ratios	SBI	SBBJ	SBH	SBIND	SBM	SBP	SBS	SBT
Net NPAs/Net Advance	-14.36	-24.53	-35.92	-25.32	-29.92	-25.25	-21.11	-23.76
Gross NPAs/Total Advance	-16.59	-21.96	-27.61	-22.68	-22.60	-22.44	-23.29	-21.84
Net NPAs/Total Assets	-9.97	-20.48	-33.52	-21.99	-27.62	-22.46	-18.51	-19.59
Net NPAs/Net Advance	-14.36	-24.53	-35.92	-25.32	-29.92	-25.25	-21.11	-23.76
Operating Expenses/ Total Income	-0.85	-0.12	-0.37	-0.48	-0.84	0.12	0.00	-0.71

Contd...

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Net Profit/Total Assets	8.24	4.19	6.05	3.42	7.77	-2.10	-12.02	14.13
Return on Total Assets	8.24	-1.83	0.80	2.61	8.01	-2.50	-4.13	9.08
Net Operating Income/Total Assets	-1.54	-2.12	-1.68	-1.72	-1.78	-1.07	-2.66	-2.14
Net Income/Average Equity	5.59	-2.76	-1.86	0.99	6.28	-0.42	-1.56	7.83
Return on Investment	-5.75	-5.90	-4.52	-5.11	-5.35	-5.91	-7.73	-5.62

Source: Data compiled and calculated form Statistical Tables relating to the State Bank of India RBI Mumbai, issues of relevant years

Table 5 reveals that in Net NPA to net advance the highest decline has been observed for SBH -35.92% and lowest decline is shown in SBI -14.36%. Gross NPA to total advance the highest decline has been observed for SBH -27.61% and the lowest decline is shown in SBI -16.51%. Net NPA to total assets the highest decline has shown in -33.52% and the lowest decline are shown in SBI -9.97%. Net NPA to net advance of SBI Group& public sector banks the highest ratio is found in SBH -35.92% and the lowest ratio is shown in -14.36%. However, when compared State Bank of India Associates the decline rate is lower for public sector banks. Operating expenses to total income the highest decline has been observed for SBI -0.85% and the lowest decline is shown in SBS 0.00%. Net profit to total assets the highest ratio has been observed for SBS -12.02% and the lowest has shown in SBP - 2.10%. Return on total assets the highest decline has been observed for SBT 9.08% and the lowest decline is shown in SBH 0.80%. Net operating income to total assets the highest decline has been observed for SBS - 2.66% and the lowest has shown in SBP -1.07%. Net Income to average equity the highest decline has been observed for SBT 7.83% and the lowest has shown in SBP - 0.42%. Return on investment highest decline has been observed for - 7.73% and the lowest has shown in SBH - 4. 52%.

Banks differ in their Share of NPA to Net Advances

Table 6: Analysis of variances of Ratios of State Bank of India and its GroupBanks differ in their Share of NPA to Net Advances

Ratios	F-Value
Net NPAs/Net Advance	NS
Gross NPAs/Total Advance	NS
Net NPAs/Total Assets	NS
Net NPAs/Net Advance of SBI Group & Public Sector Banks	NS
Operating Expenses/Total Income	*
Net Profit/Total Assets	**
Return on Total Assets	*
Net Operating Income/Total Assets	NS
Net Income/Average Equity	**
Return on Investment	NS

NS-indicates Not Significant

*-indicates significance at 5 percent level

**-indicates significance at 1 percent level

Source: Computed from Secondary Data

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To test whether there are significant differences among banks in terms a null hypothesis has been framed. The null hypothesis that there is no significant difference among the banks in terms of npa ratios has been framed. From Table 6 it can be inferred that there is significant difference between the level of operating expenses and earning capacity between banks at 1% level of significance. Similarly it has been observed that net profit on total assets and net income on average equity has shown significant difference at 5 percent level of significance.

Banks	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Public Sector	259647	297350	352109	414989	480118	548437	632740	854214	1106128	1440146	1797504
Private Sector	134769	42791	55742	67052	117075	138949	170900	218886	311985	414751	518402
Foreign	29313	29523	35617	38792	46757	52018	60507	75318	97555	126338	161133
Total	423729	369664	443468	520833	643950	739404	864147	1148418	1515668	1981235	2477039
SBI Group	97425	108425	129034	150391	164537	189204	220516	284727	371679	482270	593722

However no significant difference has been observed between the NPA ratios. Hence it can be concluded that there is no significant difference in the level and trend of NPA's between SBI and its group.

The banks should retain staff working in NPA management cells for a sufficiency long period to facilitate continuity in efforts to recover NPAs. Specialized teams should be deployed for recovery of advances, which have turned in to NPAs. The NPAs can be avoided at the initial stage of credit consideration by putting rigorous and appropriate credit appraisal mechanism. This is in order to recover the NPA debt; the judicial systems should revamp and is essential to enforce the SARFAESI act, with more stringer provisions to realize the securities and personal assets of the defaulters. Regular training on advanced techniques is necessary for personnel associated with the management of advances and NPAs.

Question

Analyse the case and write down the case facts. Also provide a Regression Analysis of NPAs from the case.

Source: Varde and Singh, "*Matching Revenues and Costs in Commercial Banks*", Prajnam (NBM), Bombay vol.x, no.3, pp.251-270.

13.8 Summary

- Managing bad loans and keeping them at the lowest level has become a keyword for the banking industry in recent years because it affects adversely financial health of a bank.
- NPAs in the Indian banking system came into existence consequent to introduction of prudential accounting norms. However, non-performing loans did exist even before the introduction of the present norms and its proportion to gross advances stood at 17.91 percent as on March 31, 1994 and this soared to 23.5 percent as on March 31, 1994.
- A slew of forces—both external and internal—contributed to high level of NPAs.
- In recent years, particularly after economic reforms, there has been substantial decline in level of NPAs in Indian banking system, touching an all time low level of 2.0 percent in 2009.

Notes

- This is because of several policy measures taken by the RBI in conjunction with the Government.
- However, the level of NPAs in Indian banks is still higher as compared to those of other countries. As such, strategic measures both at macro and micro levels need to be taken.
- It is gratifying to note that in the recent few years, the Government and the RBI have initiated several concrete measures which are now showing positive results.

13.9 Keywords

Doubtful Assets: These are those assets which are considered as non-performing for period of more than 12 months.

Funds: A sum of money saved or made available for a particular purpose. ***Loss Assets:*** All those assets which cannot be recovered.

Misappropriation: The fraudulent appropriation of funds or property entrusted to your care but actually owned by someone else.

Non-performing Assets (NPA): A debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time then such loans become non-performing assets.

Provision: The action of providing or supplying something for use.

Salvage Value: The estimated value that an asset will realize upon its sale at the end of its useful life.

Standard Asset: Standard assets generate continuous income and repayments as and when they fall due.

Sub-standard Assets: All those assets (loans and advances) which are considered as non-performing for a period of 12 month.

13.10 Review Questions

1. What are NPAs? Why should they be managed?
2. What are the primary factors responsible for non-performing assets in commercial banks in India?
3. Make a critical analysis of recent trends in NPAs in Indian commercial banks.
4. How have NPAs affected financial health of Indian commercial banks?
5. What measures have, of late, been taken to contain NPAs in commercial banks in India? What has been its impact on level of NPAs of the banks?
6. What is SARFAESI Act? How far has this legislative been effective in containing NPAs of the banks?

Answers: Self Assessment

1. 1st April 1991.
2. Non-productive assets.
3. Over 5 percent
4. 1985-86
5. Two years.
6. 12 months.

Notes

7. Uncollectible or only marginally collectible.
8. Categorization of assets.
9. 0.40 per cent.
10. 100
11. Two quarters,
12. Ineffective legal system
13. 17.7 percent ; 2.0 percent
14. credit administration.
15. Exchange of credit information
16. Rating index.
17. hypothecation

13.11 Further Readings

Books

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Notes

Unit 14: Core Banking Solution

CONTENTS

Objectives

Introduction

14.1 Core Banking

14.2 Real Time Gross Settlement (RTGS)

14.3 National Electronic Funds Transfer (NEFT)

14.4 Electronic Funds Transfer (EFT)

14.5 Asset Liability Management (ALM)

14.6 Anti-money Laundering (AML)

14.7 E-Banking

14.8 E-Cheques

14.9 Cheque Truncation

14.10 Mergers and Acquisitions in Banking

14.11 Global Banking Activities

14.12 Summary

14.13 Keywords

14.14 Review Questions

14.15 Further Readings

Objectives

After studying this unit, you will be able to:

- Elaborate RTGS, NEFT
- Discuss the meaning and uses of EFT, ALM and AML
- Explain the concept of E- banking
- Elaborate on the advantages and disadvantages of E- cheques
- Discuss Cheque Truncation System
- Discuss on the mergers and acquisitions of banks

Introduction

In the previous unit, we dealt with the provisions for NPA's and classification of NPA's. The unit also discussed about the management for NPA's. In this unit you will get an insight on the core banking technology and how the advancement in technology has led to new modes of doing business in banking. The technologies have reduced time, working simultaneously on different issues and increased efficiency. The platform where communication technology and information

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technology are merged to suit core needs of banking is referred as Core Banking Solutions. Here, computer software is developed to perform core operations of banking like entering of transactions, passbook maintenance, interest calculations on loans and deposits, customer records, balance of payments and withdrawal are done. This software is set up at different branches of bank and then interlinked by means of communication lines like telephones, internet, satellite, etc. It allows the user, i.e. the customers to operate accounts from any branch if it has installed core banking solutions. This new platform has modified the way banks are working. Most of the nationalized banks in India today support core banking, for example: State Bank of India, Punjab National Bank, Allahabad Bank, HDFC and ICICI Bank.

14.1 Core Banking

Core banking is a term used to describe the services offered by a group of interconnected bank branches. Bank customers may access their funds and other transactions from any of the member branch offices. Core Banking Solutions (CBS) is a procedure which is realized in a centralized environment, i.e. under which the data pertaining to the customer's account, i.e. financial dealings, profession, family members, income, etc. is stored in the central server of the bank instead of the branch server. This task is accomplished through advanced software by using the services provided by specialized agencies.

Core banking is the nerve centre of any banking operation. In core banking, customer of a specified branch of a particular area is a customer of the entire bank spreading its branch network across the world.

Due to its benefits, a number of banks in India in recent years have taken steps to implement the core banking solutions with a view of building cordial relationship with the customer based on the information available and according to their need offers customized financial products to the customer.

Advantages: The CBS process is beneficial both to the customers and the banks in the following ways:

Customer:

- Transaction of business from any branch.
- Less number of errors, therefore higher accuracy in transactions.
- Better funds management due to immediate availability of funds.

Banks:

- Standardization of process in the bank.
- Better customer service which leads to customer retention and increased customer dealings.
- Availability of exact and precise data & better use of available infrastructure.
- Better MIS and reporting to external agencies such as Govt., RBI, etc.
- Increased business volume with better asset liability management.

Caution In December 2011, RBI selected Bangalore based financial software testing firm Thinksoft Global Services for its Core Banking Solutions.

Notes

Caselet

Core Banking: RBI's Half-baked Directions to Banks

Almost all the banks in our country have introduced "core banking solutions" (CBS), under which, all the branches of each bank are centrally interconnected. This provides the flexibility of operating a bank account opened in one branch of a bank in any of the other branch of the same bank. But the full benefits of CBS are yet to percolate down to the banking public, as banks, barring a few, are generally slow in passing on the benefits to the banking public unless goaded by the banking regulator. As a first step in this direction, RBI has just come out with guidelines for issuance of "Payable at par/Multi-city" cheques to all eligible customers in a standard format, so that they are honoured, if otherwise in order, when presented at all different centres though the clearing houses as if they are local cheques. Since such cheques (payable at par) are cleared as local cheques in clearing houses, RBI has directed that customers should not be levied any extra charges for this service.

This is no doubt a good beginning, but the RBI should have thought of many other possibilities of offering a wide variety of services using CBS and issued a comprehensive circular covering all aspects at one stretch which would have served the cause of bank customers admirably.

Depositing Cash/Cheques in Branches other than the Home Branch

A customer of a bank in Delhi wanted to make a remittance to his son studying in Mumbai. He has many options to send this remittance, one of which is to simply credit the amount to his son's account with the bank in Delhi, whose Mumbai branch is having his son's account. So he went to the nearest branch of that bank in Delhi and asked the counter clerk whether he could deposit cash for credit of his son's account in Mumbai in the same bank, as both the branches were under CBS. He was informed that he could do so only if he was also the account holder of that bank in Delhi. Otherwise the beneficiary of the remittance would have to pay a hefty charge for receiving such a remittance. As he did not have an account with that bank in Delhi, he was asked to remit the amount through National Electronic Funds Transfer mode (NEFT), which was a cheaper mode of remittance, but the amount would be available to his son only on the next working day. If only the bank had extended the CBS benefit to the father of the account holder of the bank in another city, life would have been much simpler and the customer would have received the remittance quickly and without any hassle and cost. This is a classic case of simple things made complicated for want of understanding the customer's needs.

Updating the Passbook in a Branch other than the Home Branch

A pensioner, receiving his pension though his account with a public sector bank in Mumbai went on a long holiday to stay with his daughter in Chennai. He was very happy to see a branch of his bank nearby and went to the branch in the first week of the month to get his pass book written up just to make sure that his pension for the previous month has been duly credited to his account. He no doubt got his pass book written up, but was surprised to find a charge of ₹10 debited to his account for extending this service. He was informed that this charge was as per the rules of the bank, though, no such charge was levied for extending the same service in his home branch. The amount of charge may be small for the bank, but not for a pensioner. Is this not a case of taking advantage of customer's predicament?

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There are a number of other services like renewing or encashing a fixed deposit, payment of loan installments, even closing an account, etc. which are possible under CBS in any branch of the bank, without incurring any additional cost to the bank. By extending all these services in any branch of the bank without any extra charge, banks can win over the customers and continue to enjoy their patronage, which will help them to expand their current and saving deposits, a source of low cost deposits for the banks. These may appear small pinpricks, but they certainly go a long way in making life simpler for a large number of our people who do not have access or knowledge of internet and computers. But unfortunately, many public sector banks in our country are either slow in providing innovative services to the customers or do not bother to find out the customer's needs. They only act on getting a direction from the RBI, which alone with a little foresight can make the life of bank customers a little more comfortable and convenient in these trying times.

Source: http://www.moneylife.in/article/core-banking-rbis-half-baked-directions-to-banks/27766.html

Self Assessment

Fill in the banks:

1. Core banking is the ..... of any banking operation.
2. One advantage of CBS is that due to ..... errors, ... is high in transactions.

14.2 Real Time Gross Settlement (RTGS)

RTGS stands for Real Time Gross Settlement. According to RBI, "RTGS can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis (without netting)". This happens through the secure network INFINET provided by IDRBT, an initiative of Reserve Bank of India for research in Banking Technology. Considering that the funds settlement takes place in the books of the Reserve Bank of India, the payments are final and irrevocable.

The RTGS system is primarily meant for large transactions. The minimum amount to be remitted through RTGS is 2 lacs. There is no upper ceiling for RTGS transactions.

Did u know? CHAPS is one of the largest RTGS systems in the world.

Salient Features

Customers can remit any amount using RTGS. Customers aiming remission of money through RTGS have to provide the following particulars:

- IFSC (Indian Financial System Code) of the beneficiary Bank/Branch.
- Full account number of the beneficiary.
- Name of the beneficiary.

Task Visit your nearest bank and find out the RTGS system used and how has it proved beneficial to the bank officials and the customers.

Notes

Self Assessment

Fill in the blanks:

3. RTGS stands for .....
4. RTGS has been made possible because of an initiative of RBI which is known as .....
5. The minimum amount to be remitted through RTGS is .....

14.3 National Electronic Funds Transfer (NEFT)

The full form of NEFT is National Electronic Funds Transfer. According to RBI, "NEFT is a country-wide payment system providing one-to-one funds transfer." In this system, individuals, firms and corporates can transfer funds electronically from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. There is no limit- either minimum or maximum- on the amount of funds that could be transferred using NEFT. However, maximum amount per transaction is limited to ₹ 50,000 for cash-based remittances and remittances to Nepal. It was launched in November 2005.

NEFT has many advantages over the other modes of funds transfer:

- The remitter need not send the physical cheque or Demand Draft to the beneficiary.
- The beneficiary does not need to visit his/her bank for depositing the papers.
- The beneficiary need not be worried regarding loss/theft of physical instruments or the likelihood of deceitful encashment.
- Cost effective.
- Credit verification of the remittances sent via texts or email.
- Almost real time transfer of the funds to the beneficiary account in a secure manner.

Self Assessment

Fill in the blanks:

6. NEFT stands for .....
7. The limit on the amount of fund transfer is .....

14.4 Electronic Funds Transfer (EFT)

EFT or Electronic funds transfer refers to the computer-based systems used to perform financial transactions electronically. It is a system of transferring money from one bank account directly to another without any paper money changing hands. Direct deposit is one of the most widely used EFT programs, in which payroll is deposited straight into an employee's bank account.

It is used for both credit transfers (e.g. payroll payments) and for debit transfers (e.g. mortgage payments).

The term EFT is used for a number of different concepts

- Cardholder-initiated transactions, where a cardholder makes use of a payment card. Electronic cheque clearing.
- Electronic payments by businesses, including salary payments.

EFT may be initiated by a cardholder when a payment card such as a credit card or debit card is used. This may take place at an ATM or a point of sale (EFTPOS), or when the card is not present, which covers cards used for mail order, telephone order and internet purchases.

Notes Some of the common EFT services are:

- ATMs
- Direct Deposits
- Pay-by-phone Systems
- Personal Computer Banking
- Debit Card Purchase or Payment Transactions
- Electronic Check Conversion

Self Assessment

Fill in the blanks:

8. EFT refers to .....
9. In case of .....……deposit, payroll is deposited directly into an employee's banking account.

14.5 Asset Liability Management (ALM)

ALM stands for Asset Liability Management. It is the process involving decision making about the composition of assets and liabilities including off balance sheet items of the bank and conducting the risk assessment.

ALM is concerned with strategic balance sheet management involving all market risks. It means managing both sides of balance sheet to minimize market risk.

Thus ALM is related to the strategic management of balance sheet by giving due weightage to market risks viz. liquidity risk, interest rate risk and currency risk.

1. ALM involves planning, directing, controlling the flow, level, cost and yield of funds of the bank.
2. ALM builds up assets and liabilities of the bank based on the concept of Net Interest Income (NII) or Net Interest Margin (NIM).

Need of ALM

1. Globalization of financial markets
2. Multi-currency balance sheet
3. Deregulation of interest rates
4. Narrowing NII/NIM Prevalence of Basis Risk and Embedded Option Risk
   (a) Integration of Markets – Money Market, Forex Market, Government Securities Market Various risks are affecting banks/financial institutions Deregulation and competition
   (b) Credit, Market, Operational

Notes

Therefore, there is a:

1. Need for proper risk management policy
2. Need to manage risk to protect NIM Liquidity planning, interest rate risk management.

ALM guidelines have been issued for banks in Feb 1999 and for FIs in Dec. 1999.

Self Assessment

Fill in the blanks:

10. ALM is the process involving decision making about the .....
11. For banks, ALM was issued in .....

14.6 Anti-money Laundering (AML)

Anti-money Laundering is the term used by banks and other financial institutions to describe the diverse measures to combat this illegal activity and to forbid criminals from using individual banks and the financial system in general as the channel for their proceeds of crime.

Money laundering is traditionally done in three stages, called Placement, Layering and Integration.

1. Placement is the physical depositing of the cash.
2. Layering describes the process of transactions, some very simple, some more complicated and often involving transactions within and between banks and across borders, which seek to confuse the trail back to the original cash.
3. Integration is the process by which the money is brought back into use by the criminal in the normal economy, often by the purchase of assets (houses, cars, works of art) but which make it appear legitimate.

Anti Money Laundering processes and controls helps banks and financial institutions protect themselves and their reputation from the criminals. Vital elements of a sound Anti Money Laundering program, many of them required by law, include:

- Minimum standards and policies, approved by senior management, which clearly sets out philosophy on crime prevention and business requirements.
- Robust training program for all staff.
- Strong KYC checks at customer take-on to identify and exclude known criminals but also to be sure you know the real identity of the customers you encounter.
- Automated processes to monitor the activities on customer accounts to identify shady activity and to check incoming and outgoing payments for unauthorized transactions and to enable reports to be made to relevant authorities.

Self Assessment

Fill in the blanks:

12. The three stages of money laundering are ....., ... & .....
13. The process by which the money is brought back into use by the criminal in the normal economy is known as .....

Notes

14.7 E-Banking

E-banking is the automated delivery of new and traditional banking products and services directly to customers through electronic and interactive communication channels.

Example: Personal Computer (PC) banking, Internet banking, home banking, virtual banking, phone banking, online banking and remote electronic banking.

Electronic banking, or e-banking, is the term which describes the transactions taking place among companies, organizations, and individuals and their banking institutions. It was first conceptualized in the mid-1970s and some banks offered their customers electronic banking in 1985. The Internet explosion in the late-1990s made people more comfortable with making transactions over the web and despite the dot-com crash, e-banking grew alongside the Internet.

Electronic banking is a term combinedly used for the processes by which a customer may perform banking transactions electronically without visiting a brick-and-mortar institution.

E-banking comprises of the systems that enable banks' customers — individuals or businesses, to check accounts, do business transactions, or fetch information on financial products and services through a public or private network, including the internet.

Customers can avail e-banking services by using electronic devices, such as a Personal Computer (PC), Personal Digital Assistant (PDA), Automated Teller Machine (ATM) and Kiosk, etc.

Benefits of e-Banking

The greatest advantage of e- banking lies in the fact that customers are not required to wait in long and tiring lines of the banks for financial transactions or statements. Opening of accounts is quite easy now, there is flexibility while closing of accounts and bank loans can also be availed without having to visit any bank.

Banking has been made faster and convenient as compared to conventional banking since e-banking has tremendously reduced the time required for processing banking transactions. E-banking is cost-effective and caters to need of thousands of customers simultaneously. These factors have considerably raised the profit margins of the banks which enable them to offer acceptable interest rates on savings account and credit cards.

In addition to availing banking facilities for 24 hours a day, important information regarding banking policies, rates of interest offered and formalities required in various transactions can also be received.

While availing the facilities of internet banking, one needs to be very careful so as not to become a victim of computer hacking which may lead to unauthorized use of your account by computer hackers. Though banks have come up with several security measures, the customers are also required to be a bit careful to ensure security and safety of Internet banking.

Disadvantages of e-banking

E-Banking presents potential disadvantages:

1. ***Security:*** Although banks generally offer secure web pages to carry out your business transactions, this doesn't guarantee complete safety. Even secure websites may be susceptible to internet criminals who try to hack into your account and gain access to your financial information. This may lead to deceitful use of your business's identity and potentially cost you thousands of dollars.

Notes

2. ***Site Disruption:*** A technical fault could cause the banks website to go offline for a certain period of time, which can result in problems for you and your business. Routine site maintenance also occurs, although this normally takes place during off-peak hours.

3. ***User Apprehension:*** Some people may not feel comfortable with the idea of placing critical financial information into an online account, or may be worried about using the Internet.

4. ***Accessibility:*** If the business is located in a rural or remote area, the internet options may be limited. Depending on the type of business, conducting transactions may seem difficult.

Did u know? Stanford Federal Credit Union was the first who offered online internet banking services to all of its members in 1994.

Self Assessment

Fill in the blanks:

14. E-banking is the ..... delivery of new and traditional banking products and services directly to customers.

15. ..... of your bank account is the most important factor in online banking.

14.8 E-Cheques

E-cheques or electronic cheques are designed to accommodate the many individuals and entities that might prefer to pay on credit or through some mechanism other than cash. Once registered, a buyer can then contact sellers of goods and services. To complete a transaction, the buyer sends a cheque to the seller for a certain amount of money. These cheques may be sent using email or other methods. The electronic cheques are modelled on paper checks, except that they are initiated electronically.

Example: They use digital signatures for signing and require the use of digital certificates to certify the payer, the payer's bank and bank account.

They are delivered either by direct transmission using telephone lines or by public networks such as internet.

Because the cheque is in an electronic format, it can be processed in fewer steps and has more security features than a standard paper cheque. Security features provided by electronic cheques include authentication, public key cryptography, digital signatures and encryption, etc.

Benefits of E-Cheques

Following are the various benefits of e-cheques:

1. Well suited for clearing micro payments.

2. They create float which is an important requirement of commerce.

3. They can serve corporate markets. Firms can use them in more cost-effective manner.

Notes

Advantages of E-cheques

1. Since they are similar to traditional cheques, there is no need for customer education
2. They use conventional encryption than Public and private keys, electronic cheques are much faster.

Disadvantages and Legal Issues of E-Cash

1. E-Cash cannot be broken into smaller denominations. Accessing Database of spent notes is very time consuming.
2. Maintaining a database of spent notes is very expensive.
3. Currency fluctuation is another issue related to e-Cash.

Self Assessment

State whether the following statements are true or false:

16. E-cheques are well-suited for clearing macro payments.
17. E-cash can be broken into smaller denominations.

14.9 Cheque Truncation

Under the paper-cheque based clearing, the SBI bank will send the paper-cheque to the clearing house and get the money and then transfer it to the account. This is time consuming because SBI (or any bank) would need to physically move the cheques to a clearing house.

So RBI came up with a new idea known as 'Cheque Truncation System (CTS)'.

In this Cheque Truncation System (CTS), SBI branch will not send the paper-cheque to the clearing house, but rather, it'd merely scan the cheque, and electronically send the image + MICR data, to the clearing house.

From the clearing house, the data would go to the paying bank; they will inspect the MICR data, signature on the scanned image and release the money to SBI.

This process is faster and safer than the conventional paper-cheque clearing method.

Cheque Truncation System (CTS)

CTS stands for Cheque Truncation System and essentially means that instead of sending the cheque in physical form, an electronic image of the cheque is sent to the drawee branch for payment through the clearing house, thereby eliminating the cumbersome physical presentation of the cheque to the paying bank, thus saving the time and costs involved in traditional process.

CTS 2010 is the recent standard prescribed by the RBI for cheques issued by all banks in the country. This was introduced as a pilot project in the National Capital Region in 2008 and in Chennai from September 2011. It is suggested that the cheque clearing would be centralized into four grids, in four centres, North, South, East and West, and all the existing clearing houses across the country will be linked to these CTS grids in course of time.

The RBI has confirmed that with amendments to Sections 6 and 1(4) and with the addition of Section 81A to the Negotiable Instruments Act, 1881, the truncation of cheques has since been legalized.

Notes

What are the benefits of CTS to bank customers?

Following are the benefits of Cheque Truncated System:

1. The main feature of the CTS 2010 cheque is that it has accelerated the process of cheque clearance and settlement between banks which evidently mean quicker clearance, shorter clearing cycle and quicker credit of the amount to your account.
2. There is no fear of loss of cheques in transit and chances of cheques being lost due to mishandling, etc. are totally avoided since the movement of cheques from one bank to another having been stopped.
3. Currently, clearing is limited to banks operating within a city or within a restricted geographical area. Under the CTS, it is proposed to incorporate multiple clearing locations managed by different banks in different centres so that cheques drawn on interior banks can also be cleared electronically.
4. This will eventually result in integration of clearing houses into a nation-wide standard clearing system, thus making cheque clearance drawn on any bank in India possible within 24 hours.
5. Under the CTS system, moving of physical cheques at different points is eliminated as only electronic images are transmitted between banks, and this will substantially reduce the scope for perpetuation of frauds inherent in paper instruments.
6. It is also possible now to detect frauds easily through interception of altered and forged instruments while passing through the electronic imaging system because of the introduction of homogeneity in security features under CTS standards 2010. This is expected to reduce operational risks and risks associated with paper clearing for the benefit of all bank customers.
7. In the words of RBI, "CTS brings elegance to the entire activity of cheque processing and clearing and offers several benefits to banks in terms of cost and time savings, including human resource rationalization, cost effectiveness, business process re-engineering and better customer service."

Self Assessment

Fill in the blanks:

18. CTS was introduced as a pilot project in the National Capital Region in ..... and in Chennai from September .....
19. CTS benefits include ..... & ..... savings.

14.10 Mergers and Acquisitions in Banking

Before going further, let us understand the definition and meaning of merger:

"Merger is defined as combination of two or more companies into a single company where one survives and the others lose their corporate existence."

The survivor company acquires all the assets as well as liabilities of the merged company or companies. In India, mergers are called as amalgamations, in legal parlance.

Typically, shareholders of the amalgamating company get shares of the amalgamated company in exchange for their existing shares in the target company. Merger may involve absorption or consolidation.

Notes

"Mergers and acquisitions in banking sector have become familiar in the majority of all the countries in the world. A large number of international and domestic banks all over the world are engaged in merger and acquisition activities. One of the principal objectives behind the mergers and acquisitions in the banking sector is to reap the benefits of economies of scale."

With the help of mergers and acquisitions in the banking sector, the banks can develop significantly in their operations and minimize their expenses to a considerable extent. Another important advantage is that in this process, competition is reduced because merger eliminates competitors from the banking industry.

Mergers and acquisitions in banking sector are forms of horizontal merger because the merging entities are involved in the same kind of business or commercial activities. Sometimes, non-banking financial institutions are also merged with other banks if they provide similar type of services.

In the context of mergers and acquisitions in the banking sector, growth in size can be achieved through mergers and acquisitions quite easily. This type of growth may be described as inorganic growth. Both government banks and private sector banks are adopting policies for mergers and acquisitions.

In many countries, global or multinational banks are expanding their operations through mergers and acquisitions with the regional banks in those countries. These mergers and acquisitions are named as cross-border or international mergers and acquisitions in the banking sector. By doing this, global banks are able to place themselves into a dominant position in the banking sector, achieve economies of scale, as well as earn market share.

Mergers and acquisitions in the banking sector have the capability to ensure efficiency, profitability and synergy. They also help to grow shareholder value. In some cases, financially distressed banks are also subject to mergers in the banking sector and this may result in monopoly and job cuts. Deregulation in the financial market, market liberalization, economic reforms, and a number of other factors have acted as an important function behind the growth of mergers and acquisitions in the banking sector. Nevertheless, there are many challenges that are still to be overcome through appropriate measures.

Mergers and acquisitions in banking sector are controlled or regulated by the apex financial authority of a particular country. The mergers and acquisitions in the banking sector of India are overseen by the Reserve Bank of India (RBI).

For Example:

- Lord Krishna Bank with Centurion Bank on 29th August 2007
- Ganesh Bank of Kurundwad with The Federal Bank (6-Jan 2006)
- Bank of Punjab with Centurion Bank (29th June 2005)
- IDBI Bank with IDBI Limited (October 01, 2004)
- Global Trust Bank with Oriental Bank of Commerce (August 14, 2004)
- Nedungadi Bank with Bank of Punjab (Feb 02 2003)
- Benares State Bank with Bank of Baroda (July 19, 2002)
- ICICI Limited with ICICI Bank (March 30, 2002)

Notes

Self Assessment

Fill in the blanks

20. Government banks and private sector banks are adopting policies for …… and …….

21. Mergers and acquisitions in the banking sector have the capability to ensure ……., ……. and …….

14.11 Global Banking Activities

Banking has become a global affair now. Since the early 1980s, bankers, in association with national policymakers and officials at international financial institutions (IFIs), have largely succeeded in deregulating the global banking system. As local, domestic, and international barriers to private banking have collapsed, cross-border banking has spread dramatically, and major banks of the world have established branches throughout the globe. While the globalization of private banking has increased the accessibility of loans to governments and businesses and improved the quality of banking services for some customers, its overall affect has been negative, both nationally and internationally.

Key Points

- International banking activities often result in financial imbalance and serious economic downturns as financial markets become more open and relieved.
- Competition from multinational banks has reduced the availability of credit to small- and medium-sized enterprises, to low- and middle-income consumers, and to farmers.
- While economies experience financial instabilities and declining credit, governments are losing the means to protect their domestic markets.

The global reach of private banking has two major dimensions: cross-border lending and direct investment in the financial services sector of other nations.

- Cross-border lending occurs when a U.S. institution like Bank of America lends dollars to the Mexican government or to a company in Mexico.
- Direct investment occurs when a U.S. bank like Citibank establishes a subsidiary in a foreign country. Banks that have subsidiaries in other countries are called multinational banks (MNBs).

The largest U.S. banks do both: lend internationally and have an array of subsidiaries active in the financial services sector of many foreign countries.

The direct entry of MNBs into foreign financial markets—particularly those of low income countries (LICs)—often triggers a drop in the lending levels of domestic banks. Small- and medium-sized enterprises, consumers, and farmers are generally the first to lose access to affordable financing, while the least affected ones are trans-national corporations and domestic blue-chip companies. Reduced access to credit means that firms cannot guarantee all their investment projects, thus crushing economic growth.

The negative effects of global financial deregulation are not limited to LICs, however. To repay their international debt, countries with ailed economies focus on enhancing their exports and appealing the foreign investors. Workers in the U.S. undergo low-wage competition as imports increase and U.S. companies close domestic factories to set up shops abroad. Moreover, to

prevent fiscal crises from spreading, the IMF and lender governments organize financial bailouts that are underwritten by the taxpayers of both the LICs and the wealthier countries like the United States.

Although the perils and problems linked with deregulated fiscal flows are increasingly evident, several multilateral institutions—including the IMF, the World Trade Organization (WTO), and the Organization for Economic Cooperation and Development (OECD)—are currently negotiating new agreements that would open more markets to MNBs on an even broader scale than previous regional agreements, such as the North American Free Trade Agreement (NAFTA) and the Asia Pacific Economic Cooperation (APEC) forum. The explicit intention of the suggested rules is to create legal, political, and economic frameworks that would make it almost impossible for governments to impose controls on international capital. For example, the IMF aims to improve its articles so that member countries would need to obtain permission from the IMF to bring in capital controls; the WTO is negotiating a new agreement called the General Agreement on Trade in Services (GATS) to liberalize service sectors, including banking; and the OECD is negotiating a Multilateral Agreement on Investment (MAI), which would substantially increase the rights of international lenders and multinational banks.

Big Fish

The biggest whale in the Indian banking waters, State Bank of India, is considered to be small fry in the global banking ocean. Despite cornering about 25 per cent of the banking business in the country, SBI is ranked 60th in the list of Top 1000 Banks in the world by The Banker in July 2012. Ideally, India should have 4 or 5 global-scale banks.

Recently, the government asked SBI to do an elaborate cost-benefit analysis of its merger with its five associate banks. The bank not facing any tangible problem in merging two of its subsidiaries earlier might have worked as a trigger. Once all its subsidiaries are merged with it, it would be among the top 10 banks in the world in terms of various parameters.

Grapevine has it that recently the Ministry of Finance called the chairmen of SBI and BoI on the issue of merger and if this were to happen, SBI will become the fifth or sixth largest bank in the world. With the arrival of new century, Indian corporates are spreading their grip by acquiring companies abroad.

Notes For funding cross-country acquisitions Indian banks should acquire size and sophistication. Thus, there is no substitute for consolidation in PSU banks.

Self Assessment

Fill in the blanks:

22. In India, in legal parlance, mergers are called as .....
23. The company which acquires the assets and liabilities of the target company is referred to as .....
24. In the process of merger, competition is reduced because .....

Notes

Case Study

The Indian Internet Banking Journey

"We want to use the Internet to become a universal banking major."

In 2001, a Reserve Bank of India survey revealed that of 46 major banks operating in India, around 50% were either offering Internet banking services at various levels or planned to in the near future. According to a research report, while in 2001, India's Internet user base was an estimated 9 lakh; it was expected to reach 90 lakh by 2003.

Also, while only 1% of these Internet users utilized the Internet banking services in 1998, the Internet banking user base increased to 16.7% by mid- 2000. Many of the major banks like ICICI, HDFC, IndusInd, IDBI, Citibank, Global Trust Bank (GTB), Bank of Punjab and UTI were offering Internet banking services.

Based on the above statistics and the analysts' comments that India had a high growth potential for Internet banking, the players focused on increasing and improving their Internet banking services. As a part of this, the banks began to collaborate with various utility companies to enable the customers to perform various functions online. ICICI's 'Infinity,' which was already a leader in the Indian Internet banking arena, began to allow its customers to pay their online real time shopping bills. HDFC, through its 'payment gateway' feature, allowed its Internet banking customers to make online and real time payments for their purchases. HDFC also entered into tie-ups with various portals to provide these business-to-customer (B2C) e-commerce transactions.

As more banks entered Internet banking arena, the competition between the banks also increased. This compelled the banks to focus on capturing new markets and customers and adopting advanced technology on the Internet.

In the light of these developments, industry watchers remarked that Internet banking had arrived in a big way. Though it had a long way to go compared to the global standards, it was beginning to be seen as a replacement for the traditional banking set up in the future."

About Internet Banking

Globally, the banking business has always been in the forefront of harnessing technology to improve its services and efficiency. Banks have been quick to adopt rapidly evolving electronic and telecommunication technologies to deliver an extensive line of value added products and services to their customers. By the early 1990s, direct dial-up connections, personal computers, tele-banking and automated teller machines (ATMs) became common in most developed nations.

Internet banking evolved in the mid-1990s when Internet and the World Wide Web began to catch on. Soon, many major banks in the US and Europe began to use the Internet to provide banking services. Internet banking is a web-based service that enables the bank's authorized customers to access their account information. It allows the customers to log on to the bank's website with the help of a bank-issued identification and a personal identification number (PIN).

ICICI - Internet Banking Initiatives

ICICI bank was incorporated as a commercial banking company, by the Industrial Credit and Investment Corporation of India (ICICI), in May 1994. The first ICICI branch was started in June 1994 at Chennai. The bank provides an array of domestic and international

Contd...

Notes

banking services to enable national and international trade and business, investment and foreign exchange and treasury services. Right from its inception the bank focused more on incorporating advanced technology. The bank operated the largest chain of ATMs in the country, which amounted to more than 450 in 2000. All the bank's branches were fully computerized and networked through V-SAT5 technology...

The Future

Despite the rosy predictions and increased corporate activity, the Indian Internet banking system is facing many hurdles. The problems include operational risks, security risks, system architecture risks, reputational risks and legal risks.

Apart from the security issues, there are a host of other problems like:

- PC user base in India is extremely low compared to global standards.
- The Internet user base is limited.
- Lack of infrastructure to advanced technology based banking services.
- The absence of a regulatory framework for Internet banking transactions in India.
- The mindset of the Indian consumer, who prefers personal interactions and is not very comfortable, doing transactions through the Internet.
- Limited awareness about the potential of Internet banking on the part of banks

Question

Prepare a report on the basic concepts of Internet banking, its working mechanism and benefits.

Source: www.icmrindia.org

14.12 Summary

- Core banking is a term used to describe the services offered by a group of interconnected bank branches.
- Core Banking Solutions (CBS) is a procedure which is realized in a centralized environment
- RTGS can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis (without netting)
- NEFT is a country-wide payment system providing one-to-one funds transfer.

  Electronic funds transfer refers to the computer-based systems used to perform financial transactions electronically. It is a system of transferring money from one bank account directly to another without any paper money changing hands.
- Asset Liability Management is the process involving decision making about the composition of assets and liabilities including off balance sheet items of the bank and conducting the risk assessment.
- Anti Money Laundering is the term used by banks and other financial institutions to describe the diverse measures to combat this illegal activity and to forbid criminals from using individual banks and the financial system in general as the channel for their proceeds of crime.
- Money laundering is traditionally done in three stages, called Placement, Layering and Integration.

Notes

- E-banking is the automated delivery of new and traditional banking products and services directly to customers through electronic and interactive communication channels.
- E-cheques or electronic cheques are designed to accommodate the many individuals and entities that might prefer to pay on credit or through some mechanism other than cash.
- Cheque Truncation System means that instead of sending the cheque in physical form, an electronic image of the cheque is sent to the drawee branch for payment through the clearing house
- Merger is defined as combination of two or more companies into a single company where one survives and the others lose their corporate existence."
- Mergers and acquisitions in banking sector are controlled or regulated by the apex financial authority of a particular country. For example, the mergers and acquisitions in the banking sector of India are overseen by the Reserve Bank of India (RBI).

14.13 Keywords

Acquisition: An act of purchase of one company by another.

Anti Money Laundering (AML): It is a set of procedures, laws or regulations designed to stop the practice of generating income through illegal actions.

Asset Liability Management (ALM): It is a technique companies employ in coordinating the management of assets and liabilities so that an adequate return may be earned.

E-cash: Electronic money refers to money or scrip which is only exchanged electronically.

Electronic Funds Transfer (EFT): Electronic funds transfer is the electronic exchange, transfer of money from one account to another, either within a single financial institution or across multiple institutions, through computer-based systems.

Merger: Combination of two or more companies into a single company where one survives and the others lose their corporate existence.

National Electronic Funds Transfer (NEFT): National Electronic Funds Transfer is electronic funds transfer system, which facilitates transfer of funds to other bank accounts electronically.

Real Time Gross Settlement (RTGS): Real Time Gross Settlement systems are funds transfer systems where transfer of money or securities takes place from one bank to another on a "real time" and on "gross" basis.

14.14 Review Questions

1. Explain core banking solutions. What are its advantages to the banks and the customers?
2. "Core banking is the nerve centre of any banking operation". Elaborate.
3. What do you mean by RTGS? Discuss in detail.
4. Discuss the salient features of RTGS.
5. What are the advantages of NEFT over other electronic transfer systems?
6. Why do you think is ALM necessary in banks?
7. Explain E-banking. What are its advantages and disadvantages?
8. What do you understand by E-cheques? Also discuss its advantages and disadvantages.
9. What is cheque truncation system? How are they beneficial to the bank customers?

Notes

10. Explain merger and acquisition in Indian perspective.
11. What is global banking activities? Discus its key points.
12. Write short notes on:
    (a) AML
    (b) ALM

Answers: Self Assessment

1.	Nerve centre	2.	Less; accuracy
3.	Real time gross settlement	4.	INFINET
5.	2 lacs	6.	National Electronic Funds Transfer
7.	No limit	8.	Electronic Funds Transfer
9.	Direct	10.	Composition of assets and liabilities.
11.	Feb 1999	12.	Placement, layering; integration
13.	Integration	14.	Automated
15.	Security	16.	False
17.	False	18.	2008; 2011
19.	Cost; time	20.	Mergers, acquisitions
21.	Efficiency, Profitability; Synergy	22.	Amalgamation
23.	Acquiring company		
24.	Competitors are eliminated from the banking industry		

14.15 Further Readings

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