PRINCIPLES AND PRACTICES OF BANKING AND INSURANCE

O.P. Agarwal

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PRINCIPLES AND PRACTICES OF BANKING AND INSURANCE

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O. P. AGARWAL
M.Com., LL.B. (Hons.) C.A.I.I.B., C.A.I.B. (London),
Dip. in Industrial Finance and Co-operation,
Former – Chief Manager, Bank of Maharashtra,
General Manager's Office, Mumbai.

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Nagpur : Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018. Phone: 0712-2738731, 3296733; Telefax: 0712-2721216

Bengaluru : Plot No. 91-33, 2nd Main Road Seshadripuram, Behind Nataraja Theatre, Bengaluru - 560020. Phone: 08041138821; Mobile: 09379847017, 09379847005

Hyderabad : No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda, Hyderabad - 500 027. Phone: 040-27560041, 27550139

Chennai : New No. 48/2, Old No. 28/2, Ground Floor, Sarangapani Street, T. Nagar, Chennai-600 012. Mobile: 09380460419

Pune : First Floor, Laksha Apartment, No. 527, Mehunpura, Shaniwarpeth (Near Prabhat Theatre), Pune - 411 030. Phone: 020-24496323, 24496333; Mobile: 09370579333

Lucknow : House No. 731, Shekhupura Colony, Near B.D. Convent School, Aliganj, Lucknow - 226 022. Phone: 0522-4012353; Mobile: 09307501549

Ahmedabad : 114, SHAIL, 1st Floor, Opp. Madhu Sudan House, C.G. Road, Navrang Pura, Ahmedabad - 380 009. Phone: 079-26560126; Mobile: 09377088847

Ernakulam : 39/176 (New No. 60/251), 1st Floor, Karikkamuri Road, Ernakulam, Kochi - 682011. Phone: 0484-2378012, 2378016; Mobile: 09387122121

Bhubaneswar : 5 Station Square, Bhubaneswar - 751 001 (Odisha). Phone: 0674-2532129; Mobile: 09338746007

Kolkata : 108/4, Beliaghata Main Road, Near ID Hospital, Opp. SBI Bank, Kolkata - 700 010, Phone: 033-32449649; Mobile: 07439040301

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Dedicated to

My beloved father

Late Shri Ishwari Prasad Agarwal (died on 22nd September, 1967)

served in the Central Bank of India Ltd., Gwalior [M.P.]

and

My Mother

Smt. Rameshwari Devi Agarwal (died on 8-09-2011)

to hold my hand, as I wrote for the first time ever.

Preface to Fourth Revised Edition

Insurance and banking needs regulations to administer them and also to provide prior informations to customers or would be customers, their rights and obligations in order to have better relationship with respective institutions. As such, for banking, the regulating Acts are Banking Regulation Act 1949, RBI Act, 1934, Banking Ombudsman Act, 2009 and in Insurance business, the regulations Laws are Insurance Act, 1938, IRDA Act, 1999, LIC Act, 1956, General Insurance Business (Nationalisation) Act, 1972 and others. As such now, I have added Chapter 14 for such regulations on insurance and for role of IRDA in life and non-life insurance business. During 2015, two new Licences were issued to two banks, viz., IDFC Bank Ltd. and Bandhan Bank Ltd. As such, the total number of private sector banks has gone to 20 and public sector banks number has increased to 27. In case of insurance companies, the total number of life insurance companies has gone up to 26 and general insurance companies number is above 30. The position of health insurance companies has also risen. Not only this, new development is to take place in State Bank of India wherein 5 associate banks and Bhartiya Mahila Bank would be merged latest by March end. By the end of March 2017, total PSBs number would be 20 as against 27 at present. The total amount of banks' deposit and advances at th end of the 22-7-2016 were ₹ 96.7 lakh crores and ₹ 71.6 lakh crores respectively. Other changes are as under:

Bank Rate – 7%

Base Rate – 9.1% to 9.5%

CRR – 4%

SLR – 21.50% (from 9-2-2015)

Repo Rate – 6.50% (from 15-4-2016)

Reverse Repo Rate – 6.00% (from 15-4-2016)

Marginal Standing Facility – @7.00%

Total Number of Bank Branches – 107430 (at the end of Mach 2014)

Total ATMs – 176410 (at the end of December 2014)

The objective of this book is to provide to students the knowledge of principles and functions of banking and insurance companies.

I acknowledge thanks to my wife Mrs. Veena O. Agarwal M.A. (Eco.) for her help in completing this revised edition.

Date: 7th September, 2016

O. P. AGARWAL
704/11-D, Springleaf Building,
Lokhandwala Complex,
Kandivili (East), Mumbai – 400 101.

SYLLABUS

Modules at a Glance

Sr. No.	Modules	No. of Lectures
1	Introduction to Banking	15
2	Banking Scenario in India	15
3	Introduction to Insurance	15
4	Insurance Business Environment in India	15
	Total	**60**

Sr. No.	Modules/Units
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2	**Banking Scenario in India** Banking Operations – Types of Accounts – Banking Services – Current Scenario, Financial Inclusion and Banking Regulations and Role of RBI.
3	**Introduction to Insurance** Understanding Risk – Kinds of Business Risks – Need and Scope of Insurance – Evolution of Insurance – Principles of Insurance – Types of Insurance and Policies – Risk and Return Relationship.
4	**Insurance Business Environment in India** Growth of Insurance Business – Actuarial Role – Claim and Settlement Procedures – Insurance Regulations Role of IRDA.

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Chapter 1

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INTRODUCTION TO BANKING

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1.1 Basic Concepts Banking

Banking is different from money lending, but the two terms, usually carry the same significance to the general public. The money lender, advances money out of his own private wealth, hardly accepts deposits from general public and usually charges high rate of interest. More often, the rates of interest relate to the needs of the borrower and at times the rates may be exorbitant. On the other hand the banking is defined in section 5(b) of the Banking Regulation Act, 1949, as the acceptance of deposits of money from the public for the purpose of lending or investment. Such deposits of money from the public are used for the purpose of lending or investment. Such deposits may be repayable on demand or otherwise and withdrawable by cheque, draft order or otherwise. Thus a bank must perform two basic and essential functions: (i) acceptance of deposits and (ii) lending or investment of such deposits. The deposits may be repayable on demand or a for a period of time as agreed by the banker and the Customer. In terms of the definition, the banker can accept deposits of money and nothing Further accepting deposits from unapplied that a banker accepts deposits from anyone who offers money for such purpose Accepting of deposits for lending and investments have been the **original functions of banking** but gradually these functions were extended and others were added from time to time and presently banks perform a number of economic activities which may affect all walks of economic life.

1.2 Significance of banks

The importance of a bank to modern economics, so as to enable them to develop, can be stated as follow:

(i) The banks collect the savings of those people who can save and allocate them to those who need it. These savings would have remained idle due to ignorance of the people and due to the fact that they were in scattered and oddly small quantities. But banks collect them and divide them in the portions as required by the different investors.

(ii) Banks preserve the financial resources of the country and it is expected of them that they allocate them appropriately in the suitable and desirable manner.

(iii) They make available the means for sending funds from one place to another and do this in cheap, safe and convenient manner.

(iv) Banks arrange for payments by changes, order or bearer, crossed and uncrossed, which is the easiest and most convenient, Besides they also care for making such payments as safe as possible.

(v) Banks also help their customers, in the task of preserving their precious possessions infact and safe.

(vi) To advance money, forms the basis of modern industry and economy and essential for financing the developmental process.

(vii) It makes the monetary system elastic. Such elasticity is greatly desired in the present economy, where the phase of economy goes on changing and with such changes, demand for money is required. It is quite proper and convenient for the government and RBI to change its currency and credit policy frequently, This is done by RBI, by changing the supply of money with the changing needs of the public.

Although traditionally, the main business of banks is acceptance of deposits and lending, the banks have now spread their wings far and wide into many allied and even unrelated activities. The forms of business permissible under Section 6(1) of the Banking Regulation Act, 1949, apart from banking business are as below:

1.3 Permissible Business

(i) Borrowing, raising or taking up of money.

(ii) Lending or advancing of money either upon security or without security.

(iii) Drawing, making, accepting, discounting, buying selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debenture, certificates, scrips and other instruments and securities whether transferable or negotiable or not.

(iv) Issuing of letters of credit/travellers cheques.

(v) Buying and dealing – selling of bullion.

(vi) Buying and selling of foreign exchange including foreign-bank-notes.

(vii) Acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares debentures, debenture stock, bonds, obligations securities and investments.

(viii) Purchasing/selling of bonds/scrips/securities for clients and also for safe custody.

(ix) Negotiating of loans and advances.

(x) Providing of safe deposit vaults, and

(xi) Collecting and transmitting of money and securities.

  (a) Acting as agent for Government/local authority or nay other person.

  (b) Insure/guarantee/underwrite/participate in managing and carrying out of any issue of State/municipal or other loans or of shares/stock/debentures and lend money for the purpose.

  (c) Transact guarantee and indemnity business.

  (d) Manage and sell any property occupied in satisfaction of claims.

  (e) Acquire/hold/deal with property which is security for loan.

  (f) Undertake and execute trusts and undertake the administration of estates as executor, or trustee.

(g) Establish and support any Institution for the benefit of its present employees and may grant money for charitable purposes.

(h) Acquire, construct and maintain any building for its own purposes.

(i) Do any other business specified by the Central Government as the lawful business of a banking company. The Central Government has accordingly specified leasing and factoring as permissible, services for banks.

1.4 Prohibited Business

Section 8 of B-R Act, prohibits a banking company.

(i) From engaging directly or indirectly in trading activities and undertaking trading risks. Buying or selling or bartering of goods directly in trading activities and undertaking trading risks.

(ii) Buying or selling or bartering of goods directly or indirectly.

However, this is without prejudice to the business permitted under Section 6(1) of the Act.

(iii) As regards immovable properties, Sec. 9 prohibits a banking company from holding such property, however acquired, except as is required for its own use, for period exceeding 7 years, from the acquisition of the property. The RBI may extend this period by another 5 years, if it is satisfied that such extension, would be in the interest of the depositors of the banking company.

Banks play a very important role in a nation's economy. Banks play a pivotal role in the economic development of a country and directing the affairs of the economy in various ways. The operations of the banking system in a economy in various ways, record the economic pulse of the country. The operations of the banking business in a country. The dependence of commerce upon banking has become, so great that in modern economy and the period of globalisation, the cessation, even for a day or two, of the banker's activities would, completely paralyze the economic life of a nation. With globalization of economic activities taking place and enormous growth in international trade and cross border economic activities, the activities of banking have grown manifold and now entering into new fields of economic activities.

1.5 Beginning of Banking

In 1786, the English Agency Houses had established the Bank of Bengal at Calcutta. This heralded the beginning of modern banking in India, subsequently three presidency banks were set up, one each at Calcutta (1806), Bombay (1840) and Madras (1843), Till 1862, these presidency banks were allowed to issue currency notes. The banks in existence during the period opened branches in various cities and towns like Agra, Bombay, Madras, Shimla, and Delhi.

In 1860, the concept of limited liability was introduced in Banking. As a result several joint stock banks (2) The Alliance Bank of Shimla (3) The Oudh Bank, and (4) The Punjab National bank. Thus, by the end of 1900, there were three classes of banks in India: (i) Presidency Banks numbering 3, (ii) joint stock banks numbering 9, and (iii) Exchange Banks or foreign banks numbering 8.

The Swadeshi movement, which started in the early 1900s, gave stimulus to the growth of indigenous joint stock banks. Some of the banks established during the period were: (1) The Peoples Bank of India (2) The Bank of India (3) The Bank of Baroda (4) The Central Bank of

India. In 1921 the three presidency Banks were merged to form The Imperial Bank of India. On the eve of Independence in 1947, there were 648 commercial banks comprising 97 scheduled and 551 non-scheduled banks. Total number of offices of banks stood at 2,987, total deposits at ₹ 1,080 crore and advances at ₹ 475 crore.

During this period, the Indian stock banks specialized in providing short-term credit for trade in the form of cash credit and overdraft facilities. Foreign exchange business remained the monopoly of foreign banks. Between 1900 and 1925 many banks failed. **The Central Banking Enquiry Committee,** which was constituted by the Government of India in 1929 to examine this issue of establishing a central banking authority for India, mentioned, in the course of its discussion, some important reasons responsible for the failure of banks. They were: (a) insufficient capital, (b) poor liquidity of assets (c) combination of non-banking activities with banking activities (d) irrational credit policy, and (e) incompetent and inexperienced directors.

On the basis major recommendations of the **Central Banking Enquiry Committee, The Reserve Bank of India Act was passed in 1934** and Reserve flank of India (RBI) came into existence in **1935,** as the central banking authority of the country. In 1949, **the Banking Regulation Act (BR Act) was passed which** provided the framework for the RBI's regulation and supervision of banks. It gave wide powers to RBI to regulate, supervise and develop the banking systems. Such powers encompassed the establishment of new banks, mergers and amalgamation of existing banks, opening of new branches, closing of existing branches and shifting of existing branches to other locations. It also empowered RBI to effect on-site inspection of banks. During the period following 1949, RBI attempted to institutionalise the savings of public and to adopt a credit system suitable to the emerging needs of the economy.

From 1950 to 1969 (before nationalisation of banks)

During this period, important development took place. Firstly, the Rural Credit Survey Committee, which examined the issue of credit availability at the rural areas, recommended the creation of a state partnered/sponsored bank entrusted with the task of opening branches in the rural areas. Accepting this recommendation, the **State Banks of India Act, 1955** was passed under which RBI took control of the Imperial Bank of India, which was renamed State Bank of India (SBI). Later in 1959, the **State Bank of India (Subsidiary Bank) Act was passed enabling SBI** to take over eight princely-state-associated banks as their subsidies. The conversion of the Imperial Bank of India into State Bank of India and the constitution of the associated banks accelerated the pace of extending banking facilities all over the country.

Secondly, the need about wider diffusion of banking facilities and to change the uneven distributive pattern of bank lending was realised. Hence, to ensure an equitable and purposive distribution of credit within the available resources and keeping in view the relative priorities of developmental needs, **the scheme of social control over banks was announced in** the parliament in December 1967. The measures designed under the social control aimed at achieving a social orientation of banking within the framework of the then existing ownership. **The National Credit Control Council was set up in 1968** to assesses the demand for bank credit from various sectors of the economy and to determine their respective priorities in all allocation.

The period witnessed further consolidation in banking. At the launch of the First Five-Year Plan in 1951, there were 566 commercial banks consisting of 92 scheduled, 474 non-scheduled banks. In 1969 total number of banks declined to 89 out of which 73 were scheduled and 16 were non-scheduled.

From 1969 to 1990: Era of Nationalisation

The Indian banking scene underwent significant changes during this period.

Several structural and functional changes took place. **In July 1969, the Government of India nationalised 14 major** scheduled commercial banks, each having a minimum aggregate deposit of **₹ 50 crore.** According to the Bank Nationalisation Act, 1969, the objective and reason for the nationalisation were:

"An institution such as the banking systems, which touches and should touch lives of millions has to be inspired by a larger social purpose and has to sub-serve national priorities and objectives such as rapid growth in agriculture. small industry and exports, raising employment levels, encouragement of new entrepreneurs and the development of the backward areas. For this purpose it is necessary for the Government to take direct responsibility for extension and diversification of banking services and for the working of substantial part of the banking system" The acquisition of ownership of banks was thus to enable banks to play more efficiently the role of catalytic agent for the economic growth by extending banking facilities to the most deserving classes.

Again, in April 1980, the Government of India had nationalised another **six banks,** each having **deposits of ₹ 200 crore** or above.

Another important structural development was the **formation of the Regional Rural Banks (RRBs).** In 1973 the Government of India had set up a working committee to study the credit availability at the rural areas. The working group identified various weaknesses of the cooperative credit agencies and commercial banks and came to the conclusion that they may not be able to fill the regional and functional needs of the credit system. Therefore, the Study Group recommended a new type of institution, which combined the rural touch and experience of co-operatives with the modernised outlook and capacity to mobilise deposits possessed by commercial banks. Such institution was to carry on banking business within the local limits specified by the Government through notification. The Government of India accepted this recommendation and permitted the establishment of RRBs. The RRBs are State sponsored, region based, rural-oriented commercial banks. The Government of India accepted this recommendation and permitted the establishment of RRBs. RRBs are state sponsored, region based, rural-based, rural-oriented commercial banks set up under the **Regional Rural Banks Act 1976.** Their ownership vests with the sponsoring commercial banks, the Central Government, and the government of the state in which they are geographically located. Under this approach, **196 RRBs were set up.**

Other important events, which took place in 1970s and 1980s, are set out below:

1.1 Major Developments in Banking between 1970 and 1980s

- Setting targets for **priority sector lending** in 1973-74.
- Prescription of norms for lending and working capital limits in 1974-75.
- Prof. Chakrabarty's report on monitory system in India in 1982-83.

- Establishing of the National Bank for Agriculture and Rural Development **(NABARD)**
- Introduction of **MICR technology** in 1985-86.
- Introduction of **Health code system for bank loans.**
- Permission of banks to float mutual funds.
- Vaghul Working Group on Money Market in 1987-88.
- Establishment of the Discount and Finance House of India (DFHI) and the National Housing Bank (NHB) in 1988-89.
- **Adoption of Service Area Approach.**
- Enhancement of access to call money market in terms of number of participants.
- Establishment of the **Small Industries Development Bank of India (SIDBI)** in 1989-90.

1991 and onwards: Era of Reforms

In 1991, the Government of India had launched an **extensive economic reform programme.** As apart of the general programme, reforms were introduced in the banking sector. The main objective of the reform is to **promote efficiency of the banking systems through intensified competitive forces.** The strategy adopted is to improve operational efficiency of the banking system and to impart functional autonomy through reduced State direct intervention in the working of the institutions. In turn, this strategy involved imparting greater transparency in dealing and reporting by the entities as also developing and integrating various segments of the financial system such as call money market, debt market, foreign exchange market and capital market.

Sources of Reform Measures — Narasimham Committee Recommendations

The reform measures were based mainly on the recommendations of the Committee on the Financial sector **1991, (Narasimham I)** and the Committee on the Banking Sector Reform, **1997 (Narasimham II)**. These recommendations, in turn, had effectively provided the blue print for the reforms recommended by the Chakrabarty Committee Monetary Systems (1982) and the Vaghul Working Group of Money Market (1987).

Measures relating to Banking: External

Banking sector reform measures are both external (i.e. pertaining to operational environment and internal (i.e. relate to the working of the specific units) Important measures under the former are policy-oriented. They are:

(i) Reduction in the pre-emption of funds through lowering of the Cash Reserve Ratio (CRR) and Statutary Liquidity Ratio (SLR),

(ii) Redefining and redesigning directed credit programmes.

(iii) Dismantling administered interests.

(iv) Establishment of relevant institutional framework, including legal reforms, to improve infrastructure such as the Discount and Finance House of India, Securities Trading Corporation of India as well as the introduction of Delivery Against Payment (DAP) and Negotiated Payment Settlement System.

(v) Setting up a level playing field by redefining the roles of banks and other financial entities.

(vi) Promoting competition by permitting new banks in the private sector.

(vii) Improving financial health of banks through prescription of risk weighted capital adequacy ratios, re-capitalisation and restructuring of weak banks.

(viii) Relaxation in respect of investments simultaneously tightening the valuation principles of such investments.

(ix) Amendment to the bank branch licensing policy with a view to help banks to rationalise their branch network and to deal effectively with the loss making branches.

(x) Promoting higher standards of disclosure through prescribing and gradual tightening of norms for income recognition, asset classification and provisioning of the international lines.

(xi) Imparting flexibility in credit delivery system through withdrawing the concept of Maximum Permissible Bank Finance (MPBF) and increasing the share of loan segment in bank credit.

(xii) Setting up of special Debt Recovery Tribunals (DRTs) for improving recovery of banks loans and

(xiii) Introduction of a scheme to disclose information about willful defaults.

Measures relating to Banking: Internal

Internal reform measures are, as mentioned earlier, bank-specific. Some of the common measures are:

(i) Adoption of reporting standards comparable to the international ones.

(ii) Strengthening internal monitoring through audit and control systems through reporting.

(iii) Adoption of modem technology.

(iv) Rationalisation of manpower including the introducing of voluntary retirement scheme.

(v) Adoption of the principles of Corporate Governance.

(a) Report of the Narshimham Committee on Financial Sector Reform, and Introduction of new formats for annual accounts of the bank in 1990-91.

(b) Introduction of rupee convertibility on current account in 1992-93.

(c) Announcement of norms for floating new private sector banks, Establishment of the State Trading Corporation of India, Introducing of FCNR (B) deposit scheme and 1993-94.

Introduction of: (a) Risk weighted capital adequacy norms. (b) Prudential norms for: (i) Asset classification (ii) Income recognition and (iii) Provisioning for banks.

Valuation of investment in government securities on the basis of market prices. Constitution of debt recovery tribunals and Merger of New Bank of India with Punjab National Bank. Reduction in the number of prescribed lending rates from six to three. Introduction of 365 days treasury bills with the market related rates. Aligning the rates of interest on dated securities of the Government with the market rates. Freeing of the rates of interest on deposit subject to a ceiling.

(i) Deregulation of interest rates on loans over ₹ 2 lakh. Freedom to banks to decide their Prime Lending Rates (PLR) and to link loan rates to their PLR. Permission to

the Nationalised Banks to raise capital upto 49% of equity from capital market and Setting up of the Board for Financial Supervision (BFS). Amendment to the State Bank of India Act to allow the bank to access equity market. Reduction in number of interest rates on advance from 4 to 3 and lowering of the floor lending and deposit rates. Budget provision of ₹ 5,700 crore to re-capitalise banks to enable them to meet new provisioning norms. Prescription of prudential norms for maximum non-performing assets. Establishment of Debt Recovery Tribunals in 1994-95.

(ii) Introduction of the Banking Ombudsman Scheme. Streamlining of the cash credit system. Freedom to banks to decide their Prime Lending Rates (PLRs). Abolishment of Minimum Lending Rate on loans above ₹ 2 lakh. Conclusion of the Agreement between the Government of India and the Reserve Bank of India on *ad hoc* Treasury Bills in 1995-96.

(iii) Implementation of measures to strengthen market in government securities. Permission to the banks to purchase bonds of the Public Sector Units in the secondary market. Introduction of the concept of Local Area Banks. The State Bank of India (SBI) issued Global Depository Receipt (GDR) and became the first Indian bank to be listed overseas. Six firms, promoted by banks and financial institutions, were granted licence to operate as Primary Dealers (PDs) in the Government Security market in 1996-97.

(iv) Operationalisation of first Shared Payment Network System. Granting of conditional autonomy to the public sector bank. Constitution of the Board for bank frauds. Announcement of norms for setting up Local Area Banks. CRR was cut from 13% to 10%. and Banks PLR in 1997-88.

(v) Report of the Narasimham Committee on Banking Sector Reforms, Revision of capital adequacy norms and deregulation of interest rates on term deposits. Deregulation of the rates on interest on foreign currency deposits to more than "LIBOR" rates. Relaxation in fixed interest rate regime and amendment to the Reserve Bank of India Act empowering it to supervise Non-Banking Financial Companies in 1998-99.

(vi) Issuance of guidelines on asset liability management in 1999-2000. Tightening of the provisioning norms for government securities and State government guaranteed loans. Assignment of risk weights to the Government securities, State Government guaranteed loans and foreign exchange open positions. Introduction of Kisan Credit Cards. Permission to banks to operate different PLRs for different maturities of loans. Merger of the Times Bank with the HDFC Bank. Listing of the ICICI Bank and the ICICI on the New stock Exchange after the issue of their respective ADRs.

(vii) In 2000-01 Announcement of the decision of the Government to reduce its equity holding in PSBs to 33% without losing their Public Sector Character and Advise to the banks to formulate risk management policies and to create operational set up for this task. Amendment to the Banking Companies (Acquisition and Transfer) Acts to allow the nationalised banks to Center the insurance sector. Introduction of a Voluntary Retirement Scheme (VRS) in the Public Sector Banks, about 11% of bank employees availed the opportunity. The Reserve Bank of India's permission to the non-banking financial companies to convert themselves into banks. Large industrial houses were not allowed to start banks; they were also not allowed to hold more than 10% of total equity in bank. The Bank of Madurai merged with the ICICI Bank. The

RBI cut Bank rate and CRR to combat slowdown. Modern bankruptcy provisions were included in the Companies Act. The Sick Industries Companies Act was repealed. The Board for Industrial Finance and Reconstruction was dissolved. Legislative measures were initiated to reduce the shareholding of the Government on the nationalised banks to 33 per cent. The Reserve Bank of India announced revised norms for establishing new banks in the private sector. The banks and NBFCs were permitted to undertake insurance business. The Reserve Bank of India announced the transaction to a full-fledged Liquidity Adjustment Facility. The norms of banks' exposure to the capital market were relaxed. Measures to improve credit delivery system were announced. The Government announced its resolve to enable the banks to effect speedier recovery of funds locked up in NPAs. Minimum maturity period for certificate of deposits was reduced from 3 months to 15 days. Norms for the issue of commercial papers were made more flexible. A system of consolidated reporting including the accounts of subsidiaries was introduced. Strong banks were allowed to enter insurance business. The State Bank of India raised ₹ 25,662 crore under the India Millennium Deposits (IMD) from the Non-Resident Indians. A proposal for the close monitoring of suit filed and decreed accounts on an ongoing basis was initiated.

To restore the soundness of public sector banks, capital adequacy ratio was introduced in 1992 and this was accompanied by recapitalisation of banks by the Government. Between 1992-93 and 1998-99 the Government contributed over ₹ 20,000 crore to the capital of public sector banks. New initiatives were taken to strengthen the supervisory system for banks by moving towards consolidated supervision and also towards risk-based supervision.

The response of the banks to the reforms has been impressive. The banks have been adjusting very well to the new environment, though gradually. As at the end of March 2001, 23 out of 27 public sector banks had capital adequacy in excess of 10 per cent, tile prescribed ratio being 9 per cent, 15 nationalised banks fell into this category i.e. exceeding 10 per cent. There has been considerable reduction in non-performing assets (NPAs). The ratio of gross NPAs to gross advances which was 23 per cent in 1992-93 declined to 12.4 per cent by March 2001. Net NPAs to net advances was 6.7 per cent in 2001. Net profits of public sector banks amounted to ₹ 2,095 crore in 2001 as against a net loss of ₹ 4,705 crore in 1993-94. Deposits mobilised, increased four-fold between 1992 and 2000, the share of time deposits being 80 per cent in 2000. Credit deployed in 2000 showed a fourfold increase over 1991. The share of credit to priority sector in total bank credit was a little over 30 per cent. In 1992-93, the first post-reform year, 12 out of 27 public sector banks reported net losses; by March 2001 only 2 banks recorded net losses. The striking feature of the banking system during 1991-2001 is its continuing branch expansion. By March 2001, there were 65,901 branches and the share of rural and semi-urban branches together was 70 per cent indicating the wide reach of the banking system. There is little doubt that the benefits of the banking reforms have been considerable.

Fourth phase: Beyond 2002

New Challenges

The first phase of financial reforms laid the basis for a sound banking system. Considerable progress has been made in implementing the reforms and the banking systems now moving towards the second phase. Nevertheless, the Indian banking system faces several difficult challenges; therefore, the banks have to re-orient their strategies in the light of their own strengths and the kind of market, in which they are likely to operate. Some

of the challenges are home-grown, e.g. high cost of doing business; level of non-performing assets and low levels of customer satisfaction. Some of the challenges are external e.g. phenomenal growth in the volume of capital inflows, integration of financial markets across the globe. In view of these domestic and international developments, it is necessary to chart out a path for the development of efficient banking in the new century. There are several areas of concern which need to be addressed.

New Dimension

Indian banks started to operate in a deregulated competitive financial sector. Competitive pressure was building up for Indian banks both from within and from outside. Competition is likely to intensify in the coming years within the industry, from NBFCs and from foreign entities. Competition is not just in terms of number of competitors but in terms of proliferation of innovations, specialised markets, cross- border trade in financial services and capital flows. Our reforms have made progress but we have not become competitive internationally. We cannot lag behind other countries and we have to transform the Indian banking system from being a largely domestic one to a truly international one and this should enable India to emerge as an international banking centre.

The worldwide revolution in information and communication technology (ICT) has become the biggest force of change in banking. It is a source of productivity growth and facilitates effective competition. ICT reduces costs, increases volumes and facilitates customized products. It plays an important role in the system. Technology has opened up new avenues in banking for discharging the same functions in a costeffective manner: 24-hour banking, telebanking; internet banking, E-banking. The process of technological change is just beginning in Indian banking. Even the use of existing technology is at low levels.

Though RBI and the banks have been taking steps for fully computerisation of all bank branches with emphasis on critical areas relevant to management and customer service and customized products. The Indian banking system will have to redouble its efforts to build the technological infrastructure not only to provide cost-effective and competitive customer service but also to achieve international recognition and status.

("The worldwide revolution in information and communication technology (ICT) has become the biggest force of change in banking.")

1.6 Origin of Indian Banking Need for Bank's Services – in Present Situations

The old world of banking has changed considerably. The forces of globalization and technology have resulted in increasing integration of economies across the world.

(i) Today, banks are ***no more competing locally,*** but in the global market place. It is important for banks to adopt to this new environment. It is said that Life is a Change while Growth is optional.

(ii) ***Banking has seen rapid deregulation.*** Today's customers have a wider range of products to choose from. In order to service this ever increasing customer demand, banks, which were highly branch focused, are concentrating on multi-channel delivery. This enables them to reach out to customers in any part of the world.

(iii) Increasing ***pressure on spreads,*** the focus on fund based income has shiffed to fee

based income as banks try to optimize this important source of income.

(iv) ***Interest*** rates have been ***deregulated.*** Now every bank is allowed to quota its own rate of interest for deposits and advances.

(v) There is provision for ***foreign currency clearing*** in the domestic market.

(vi) World's first country, where liquidity and interest rate risk ***management is mandated*** by the Central Bank, i.e., R.B.I.

(vii) The challenge is to ***integrate silos of information;*** of customer management, and of effective risk management, in order to explore newer opportunities. Operations and processes, which are largely manual need to be more customer centric. Product management, made sluggish by inaedequate technology support, should be driven by time to market parameters.

(viii) ***Employees need to be trained*** and ***redeployed*** as per business requirements.

(ix) In the present environment, a ***paradigm change in the Indian banking*** industry is inevitable. Technology can be a key business enabler in 4 critical areas, operational efficiency/customer management/product management and distribution and reach.

(x) Banks need to ***maintain high levels of operational efficiency*** in order to be competitive. For this, the key is to make optimal utilization of the resources at their disposal.

(xi) ***Organisations*** typically focus on a ***achieving short term efficiency.*** However, we need to devise strategies for achieving ***long term operational efficiency.*** This required banks to adopt new and better ways of managing their operations cross functional efficiencies have a long term impact on your business.

(xii) Customer management is more crucial today than ever before. ***Globalisation*** and the information revolution ***have raised customer expectations;*** they expect custom services at ever greater speed. They demand quality services at reduced costs. At the same time, customers can choose the most competitive service provider from anywhere in the world.

(xiii) Knowing and understanding that customer is essential. ***"One face one voice"*** slogan is easier said than done. It calls for a fundamental change in our approach to customer and in the bank's culture. However, the flexible products, excellent services and multiple channels have limited values without an integrated customer strategy. Today, banks are in a position to capture a large amount of data about customers. This should be used to enhance business intelligence in order to deepen relationships with customers. This would enable the banks to become more responsive to customer needs.

(xiv) Technology enables ***banks to increase productivity*** and to rapid by respond to changing expectations of customers. For instance, account statements, (which were previously sent by snail-mail) can now be instantly e-mailed. Further account opening, which required visit to the branch can Now be done online.

(xv) The ***choice of channels*** through which customers can transact their business, ***has grown dramatically*** in the last few years. Multi-channel banking has proved to be effective in reaching out to customers. It is no longer an either/or option. A large and fast growing section of the urban and semi-urban population in India has worken to the convenience of electronic channels. Their experience will only drive them to want

more.

(xvi) Customer preferences within the electronic delivery channels have increased. ***ATMs and customer callcenters are preferred.*** However some customers still prefer to visit the branch office even at the cost of longer transaction time. Further, customer segmentation can help in pricing various transactions. Thus, it is important to formulate a clear plan for distribution and reach. This will help migrate high volume low value accounts to the low – cost channels.

(xvii) The customer-facing team should be ***sensitive to customer expectations*** at multiple touch points of the banks. This will help deliver a unified and consistent experience across all these touch points. Banks need to impart continuous training to the staff, callcenter agents, Direct Sales Agents (DSA) and other customer-facing employees. The frontline team should also be empowered to take informed decisions to support customer services and to gear up to handle sudden spurts in transaction volumes.

(xviii) ***Product management*** should be focused on enabling rapid time-to-market and on ensuring profitability, Banks must leverage technology to customize, and to improve the quality and range of products. Further, banks should identify profitable products and corresponding customer segments.

(xix) Subsequent to interest rate deregulation, banks have a lot of ***flexibility in product pricing.*** In fact banks have to change their product pricing to derive advantages.

(xx) Another point to consider is how we can leverage technology to offer innovative and hybrid products to customers. ***Mutual funds and insurance products are*** very much part of a **bank's product** offering today. Product positioning is another key challenge. The positioning strategy enables you to differentiate in a cluttered market. The objective is to obtain top of the mind, recall among the customers.

(xxi) We have to consider ***organizational redesign, change management*** and a business plan to back it up. Organisational redesign is not a one time activity at the start of a project, it is an ongoing process.

(xxii) We need to focus on ***managing cost efficiencies*** and on increasing profits. This means that irrespective of the size of the project, every new initiative must have a business plan backing it. There should be a clear and acceptable case for ***Return on Investment*** (RoI).

(xxiii) Bringing about change required a mind set a mindset that makes us determined to change the way we operate today. For this, one need to **raise the *aspirations of employees,*** they should dream world-class. They have to believe in themselves. Aspirations energize to overcome limitations posed by the context. They sustain hope, the main fuel for progress. They help us achieve miracles. ***When one is faced with a decision, the best thing is to do*** the right thing the next best is to do the wrong thing and the worst is to do nothing.

(xxiv) Corporate banking is becoming an important part of banking activity in India. This is due to opening up of the economy/competition (internal and external) problems of size and cale, the range of financial services required and ***rapid advances in information technology,*** changing economic environment.

(xxv) It is becoming more and more non-fund based and more ***and more service-oriented***

and more and more, technology-oriented.

(xxvi) There are compelling reasons for banks, to take on a new role, *viz.,* (i) banks have to preserve their existing market share in the face of competition and enhance it (ii) Banking reforms have resulted in intermediation process, banks continue to be the corporate anchor (iii) though retail banking is buzz word, a good chunk (45%) of banks' in come is from corporates (iv) to survive, banks have to make profits.

(xxvii) ***Wholesale banking is to be combined with retail banking,*** for balanced asset portfolio. Banks have to have a relook at their pricing policy. The method of pricing should change from ***'cost plus' to product quality*** (in terms of urgency, convenience and variety) In other words, value additions should form the basis of pricing of bank's products.

(xxviii) These are the **days of *relationship banking*** in the sense that it needs to be managed in the interests of both the banks and customers. This is ***customer relationship management*** (CRM). The present method of evolving banking products and then looking around for customers for those products would not yield the desired results. It is necessary to take into account what the customers want, when they want and how they want.

(xxix) ***To enlarge bank's market share,*** customer satisfaction and to provide cash management services to corporates optimization of liquidity through inproved flow of funds in essential in highly competitive environment. Where time is money, cash management services are of many kinds, collection services, disbursement services, global trade services, investment services.

(xxx) Use of internet banking to remove cumbersome and expensive paper system. Bank should use technology for moving into the phase of ***centralized banking*** or core banking, to serve the corporates better. This should be done by integrating existing technology branches into a common business resourcing center.

(xxxi) The process of discordant by government will spur local mergers and acquisitions. Banks will be called upon by corporate sector to facilitate mergers and acquisitions by appropriately funding the process. Banks have to build up expertise in this area and evolve suitable mechanism for funding. Mergers and acquisitions, as an investment.

(xxxii) Fluctuating exchange rates affect not only export/import values of corporates but also their balance sheet values i.e. their liabilities and assets, to the extent, the corporates have external borrowings and investments. Banks need to be set up foreign exchange advisory services for covering their exports and imports the timing of their foreign currency borrowings, covering forex risks, e.g., swaps, forward rate agreements, cross currency options and derivatives.

1.7 Banking as an Ancestral Service

For the history of modern banking in India, a reference to the English Agency Houses in the days of East India Company is necessary. Those agency houses, with no capital of their own and depending entirely on deposits, were in fact trading firms carrying on banking as a part of their business and vanished from the scene in the crises of 1829-32. In the first half of the 19th century, the East India company established, 3 banks The Bank of Bengal in 1809, the Bank of Bombay in 1840 and the Bank of Madras in 1843.

The Bank of Bengal was given Charter with a capital of ₹ 50 lakhs This bank was given powers in different years as to:

(i) Rate of interest was limited to 12%.
(ii) Power to issue currency notes was given in 1824.
(iii) Power to open new branches given in 1839.
(iv) Power to deal in inland exchange was given in 1839.

These 3 banks were also known as Presidency Banks. The currency notes issued by presidency banks were not popular those were replaced by Government Paper Money in 1862. In 1860, the principle of limited liability was introduced in India in Joint Stock banks, to avoid mushroom growth of banks, which fasted mostly due to speculation, mismanagement and fraud. During the crises in between 1862-65, numerous banks failed, including Bank of Bombay. The Bank of Bombay was later restarted in the same year, with the same name. Due to failure of banks, during 1862-75 only one bank was established in 1865, i.e., the Allahabad Bank Ltd. Indian banks restarted functioning in the year 1894, when the Indian mints were closed to the free coinage of silver. The only important bank registered after the closure of the mints was the Punjab National Bank Ltd., with its head office at Lahore in 1895.

In the Swadeshi movement, number of banks were opened by Indians during 1906-13. Those new banks were:

1. Peoples Bank of India Ltd.
2. Bank of India Ltd.
3. Central Bank of India Ltd.
4. Indian Bank Ltd.
5. Bank of Baroda Ltd.

This boom of opening new banks was overturned by the most severe crises of 1913-17. Therefore the period of amalgamation started. All the three presidency banks were amalgamated on 27th January, 1921 and the Imperial Bank of India was established. This bank was allowed to hold Government balances and to manage the public debt and clearing houses till the establishment of the RBI in 1935. With the passing of the State Bank of India Act, 1955, the undertaking of Imperial bank of India, was taken over by the newly constituted SBI. It had the largest number of branches, which gave it the privilege of conversion into Government business institution of the country.

Pursuant to the provisions of the State Bank of India (Subsidiary Bank) Act, 1959, the following banks were constituted as subsidiary of SBI:

- State Bank of Bikaner & Jaipur
- State Bank of Indore
- State Bank of Travancore
- State Bank of Hyderabad
- State Bank of Patiala
- State Bank of Saurashtra
- State Bank of Mysore

In 1960, the Palai Central Bank in Kerala failed and that gave suspicion to the depositors. As such Deposit Insurance Credit Guarantee Corporation (DIGGC) was established to guarantee repayment of deposits up to ₹ 10,000 to each depositor in case of failure of banks.

On 19th July, 1969, 14 Joint Stock banks were nationalized which were having minimum depositors ₹ 50 crores and above. This brought into its fold 50% of banks' operation. Again in April, 1980, 6 more banks were brought under area of natioalised banks, to total business of 95% in its fold. These 6 banks were given tough competition to nationalized bankers and were indulged into irregularities causing concern to depositors.

Business Position of scheduled banks as on December, 2011

- Deposits ₹ 53,21,641 crore
- Credits ₹ 39,50,383 crore
- Bank Rate 6% Per cent (even in December, 2012)
- Prime Lending Rate (PLR) in between 15%-16%
  *Base Rate 10.30%-12%
- CRR 4.50% (from 17.09.2012)
- SLR 23% (from 11-08-2012)

Presently, as a part of deregulation many new generation private sector banks have been permitted *viz.,* ICICI/(IDBI)/HDFC and the nationalized banks are being privatized to the extent of 49%.

1.8 Main Functions and other Services of Commercial Banks: The Functions of Banks are mainly:

- Deposits accepting
- Fund based advances
- Fee based services
- Remittance of funds
- Collection of cheques and payments of cheques
- Agency functions
- Merchant banking
- Leasing hirepurchase functions and factoring services

(i) Deposits: are the main source of funds for commercial banks, which play a very important role in the economic life of the nation, through their assistance to trade, commerce, industry and agriculture. The owned funds of banks are a comparatively negligible portion of the total working funds, with which banks carry on banking business.

The bulk of the ***total liabilities*** a banking company comprise deposits. The volume of deposits with a particular bank indicates not only the confidence, which the public reposes in it but also its ability to assist the economic activities and growth and development of a country. Such deposits are mainly:

- Demand deposits – payable on demand.
- Time deposits – payable on the expiry of earlier decided period or term.

The demand deposits are Current/Savings and Call deposits while time (term) deposits mean Fixed/Recurring/Short Term/Flexi/Cumulative deposits, etc.

Current Accounts

A current account is a running account and is usually opened for the purpose or business. A current account is meant for the convenience of his customers, who are relieved of the task of handling cash themselves and to take the risks inherent therein. Current account may be opened by individuals, proprietorship/partnership firms, limited companies, associations/societies, local bodies/government departments, liquidators/receivers, etc. For opening an account the customer has to fill in the prescribed account opening form and provide an acceptable introduction to the bank. As per present practices in India, the customer has to provide proof of address as well as Permanent Account Number (PAN) given by the Income Tax department along with photograph of the account holders and specimen signatures of the persons authorized to open the account. A customer is required to deposit the prescribed initial amount to open the account and to always maintain the minimum required credit balance in the account. The customer can pay in cash/cheques for collection and draw cheques freely to suit his business requirements. There is no restriction on the number and the amount of withdrawals from a current account.

The customer is provided with cheque books for drawing cheques to draw money from the account and/or to make payment to third parties. In a current account, the banker incurs an obligation to pay all cheques drawn by the accountholder so long as there is sufficient balance to his credit and the cheques drawn are technically in order. The account holder is obliged not to draw cheques without maintaining a sufficient balance to his credit. In a current account there is no limit on the amount or the number or withdrawals. No interest is allowed in the credit balance in a current account. Banks also charge some incidental/ service charges for rendering services in current accounts.

Agreements can be made in current accounts to allow overdrafts, which may be clean or secured. Overdraft may be allowed by the bank for a temporary period or for a longer period depending upon, the requirement and relationship with the customer. Banks may allow facilities like bills purchase/discount to approved current accountholders.

Savings Bank Accounts

A savings bank accounts is meant for the people of the lower and middle-classes who wish to save a part of their current incomes to meet their future needs and also intent to earn income from their savings. These accounts are opened for the purpose of encouraging the saving habit. Savings bank accounts may be opened by individuals, guardians on behalf of minors, clubs/associations, charitable trusts/religious institutions and similar bodies. Savings bank accounts cannot be opened for trading/business concerns/limited companies/ government departments, etc. For opening an account the customer has to fill in the prescribed account opening form and provide an acceptable introduction to the bank. As per present practices in India the customer has to provide proof of address as well as Permanent Account Number (PAN) given by the Income Tax department along with photograph of the account holders and specimen signatures of the persons authorized to open the account. Interest is allowed on the daily balance maintained in the account. Interest is credited in the account on half-yearly intervals, @ 4% rate of interest (three private sectors are giving higher than 4% for average balance holders of ₹ 1 lakh and above). The number of withdrawals and the maximum amount which can be withdrawn, without prior notice, at a

time is not restricted. Banks may frame rules in the regard, which may vary from bank-to-bank and from time-to-time. Withdrawals from savings bank accounts may be effected either through a withdrawal form or cheques issued from the cheque book pertaining to the account. RBI has deregulated saving bank deposit interest from November, 2011 for deposits over ₹ 1 lakh and three private sector banks viz., YES BANK/INDUSIND BANK and HDFC have started paying higher interest upto 7%.

Call Deposits

Call deposits are accepted from fellow bankers and are repayable on demand. Interest on call deposits normally depends upon demand for the money and its supply in the financial market. The SBI has started such deposits from November, 2011 for deposits for 7 days to 100 days by locking period of 7 days @ 8.5%.

Fixed Deposits

In this category are included the deposits with the bank for a fixed period which is specified at the time of making the deposit. Fixed deposits are accepted for a specified period and carry a specified period and carry a specified rate if interest. The deposits are repayable on the expiry of the specified period, chosen by the depositor. The depositor agrees not to withdraw the amount earlier. At the end of the specified period, the depositor may either withdraw the amount of renew of deposit for a further specified period. The fixing of the period, enables the banker to deploy the funds suitable without fear of demand for withdrawal, deposits during the specified period of deposit. As the date or repayment or a fixed deposit is determined in advance, the banker need not keep more cash against it and can utilize such amount more profitably. The banker, therefore, offered higher rate of interest, in October 2008, it was 11% for 1,000 days by SBI on such deposits because the depositor parts with liquidity for a definite period. Fixed deposits provide stable funds to banks and are therefore very popular among bankers.

After application of Base Rate in banks with effect from July, 2010, the advances sanctioned by them would be not below the base rate of the bank (which ranges from 11.50% to 12.00% in different banks). However, this base rate has also been attached by bank., i.e., State Bank of India in fixed deposit interest rates also. For the senior citizens (since they were getting till now 0.5% extra interest on their deposit amounts) with effects from 6th September, 2010. This base rate, under fixed deposits would be floating rate and could vary after every guaranter of half year, as soon as there is an alternation in the base rate of the bank.

Hence, the senior citizens who were availing fixed interest rate, on their deposits till the expiry of deposit date, would now be getting changed (wheter lesser or higher) interest at the end of every quarter. The main feature of this floating interest rate is that there is inflation in the economy, then the interest rates could go up but could reduce, if inflation falls. The floating interest rates on fixed deposits declared by SBI effect from 4-9-2010 are:

– one year deposit – 0.5 less than base rate

up to 3 years – 0.25 less than the base rate

up to 5 years – equal to base rate.

When a fixed deposit is accepted by the banker he gives the depositor a receipt mentioning the date of deposit, the name of depositor, the rate of interest allowed on such deposit and the period for which the amount is deposited. The due date of deposit is also mentioned on the receipt.

The rules governing deposits are printed on the reverse of the receipt for the information of the depositor. These receipts are not transferable, i.e., they cannot be transferred by endorsement. However, the proceeds of the deposit receipt may be paid to a third party or to a collecting banker on the due date if the receipt is sent duly discharged together with a suitable letter of authority signed by the depositor authorizing payment to a third party or the collecting banker as the case may be.

If a deposit receipt is lost or stolen, the amounts can be paid to be depositor on the due date on obtaining an indemnity, as a deposit receipt is **not a transferable instrument** and its transfer has no legal value. In case of renewal/repayment of deposit receipt, surrender of duly discharged receipt, by the depositors necessary.

Interest on deposit ceases to accrue on overdue receipts after maturity of the receipt but the banks may, at their discretion, allow interest, thereafter if the fixed deposit is renewed from the date of its maturity till a future date.

A fixed deposit receipt is accepted for a fixed period and need not be repaid before the due date. However, if the depositor is in need of money before the due date the banker may consider favourable the request for prepayment. In such cases the interest is paid at rates lower than the rates applicable for the period for which the deposit has run. Alternatively, the banker may grant the depositor an advance against the deposit after retaining margin. The interest charged on advanced against deposit is generally 1-2% higher than the rate payable on deposits.

Recurring Deposits

With the object of giving the small depositor an incentive and convenience to save, banks allow recurring deposit facility to their customers. This facility is intended to inculcate the habit of savings on a regular basis as an inducement is offered in the form of a comparatively higher rate of interest than the saving bank. Under these, the depositors may pay a fixed sum of money, every month for various periods, say 12 to 120 months. The depositors may pay the money in easy installments and get attractive interest rates. There is also an element of compulsion in the recurring deposit scheme and the depositor can conveniently build up a sizable amount over a period. The depositor, if he so desires, may get back the money deposited by him even before the stipulated period. In such cases, the interest payable by the bank will, however, be at a rate lower than agreed at the time of opening of account.

These are the broad categories of deposits accepted by banks. However, banks may develop various products by incorporating various customer-friendly and attractive features/ services in such deposits such as periodicity of payment of interest, reinvestment facility for principal or interest, before maturity payment of term deposits, etc. Some of the examples of such deposits are as under:

Reinvestment Plan

Under this scheme of fixed deposits the interest accrued on fixed deposits is periodically and automatically reinvested in the fixed deposits with the same rate of interest and is paid to the depositor on maturity of the deposit. Such schemes are designed to facilitate maximum return to the depositor by way of reinvesting the element of interest at the same rate.

Flexi-deposits

Under this scheme the amount over and above a certain predetermined level, is transferred from a savings/current account, to a term deposit account automatically, in certain predetermined amount of units for a predetermined period and such amount starts earning higher rate of interest. Whenever, when there is a shortfall in current/savings account and the balance is not sufficient to pass the cheques/meet the requirements, the requisite amount is transferred from the term deposit account by breaking and making premature payment or equivalent units to meet the shortfall in the account.

1.9 Advances and its Importance

As has been mentioned earlier banking involves accepting of deposits from public for the purpose of lending or investment. Lending of funds to the constituents, mainly traders, business and industrial enterprises constitute the main business of any bank. Advances comprise a large portion of a bank's total assets and form the backbone of the bank's structure. Advances play an important part in gross earnings of banks. The major part of banks' income is earned from interest and discount on funds lent by them. The income so earned is used for payment of interest to its depositors and also for payment of salaries to its employees and dividend to shareholders. If a bank does not make advances or investments and keep the funds idle it will not earn income and consequently will not be able to pay depositors/employees, etc., and consequently, will not be able to carry on business profitably. The strength of a bank is primarily judged by the soundness of its advances. Thus, the advances of a bank play a very important role in operations of a bank.

Principles of Sound Lending

The business of lending carries certain inherent risks. A large percentage of bank's funds consist of deposits on different terms, repayable according to the contractual obligations with the depositors. Largely depending on the borrowed funds a banker cannot afford to take undue risks in lending. While employing his funds, a banker keep uppermost in his mind the imperative necessity of meeting his commitments as and when they arise, without slightest delay or equivocation. Subject to its ability to pay its depositors as and when the deposits fall due, a banker deploys fund in advances and investments in such a manner, which brings in the maximum returns. While lending his funds, a banker, therefore, follows a very cautious policy and conducts his business on the basis of certain principles of sound lending in order to minimize the risks.

Principles of Sound Lending

(1) **Liquidity** of funds lent
(2) **Profitability** should be there in all advances
(3) **Diversificaiton** – Spread of risks over a large number of borrowers.
(4) **Productive Purpose** – Loan should have a definite source of repayment.
(5) **Security** – Security is considered insurance. Good security must have qualities of Marketability, Ascertainability, Stability and Transferability (MAST).

There are certain cardinal principles of good lending that have been followed by commercial banks since long. These are the principles of safety, liquidity and Profitability, spread diversification, purpose and security.

Safety: 'Safety First' is the most important principles of good lending. As the bank lends funds entrusted to it by the depositors the first and foremost principle of lending is to ensure the safety of funds lent. By safety is meant that the borrower is in a position to repay the loan along with interest, according, to the terms of the loan contract, which depends upon the borrower's capacity and willingness to pay. While the capacity of the borrower depends upon his tangible assets/financial strength and success of his business/ earning of profit from business to repay the loan, the willingness to repay depends upon the honesty and character of the borrower.

The banker should, therefore, take utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying it out successfully and also that the borrower is a person of integrity, good character and reputation. In addition to the above, the banker should consider the security of tangible assets owned by borrowed to ensure the safety of his funds.

The banker should ensure that the money advanced by him goes to the right type of the borrower and its utilized in such a way that it will not only be safe at the time of lending but will remain so throughout, and ultimately after serving a useful purpose in the trade or industry, where it is employed, is repaid with interest.

Liquidity

It is not enough that the money will ultimately come back; it is also necessary that it must come back more or less on demand or within settled schedule of repayment programme under which loan was granted. Banks are mainly intermediaries for short-term funds and, therefore, generally they lend funds for short periods and mainly for working capital purposes. The borrower must be in a position to repay, within a reasonable time after a demand for repayment is made.

Profitability

Equally important is the principle of 'profitability' in bank advances. Commercial institutions, banks must make profits. Firstly, they have to pay interest on the deposits received by them. They have to incur expenses on establishment, rent, stationery, etc. They have to make provision for depreciation of their fixed assets and also for any possible bad or doubtful debts. After meeting all these items of expenditure which enter the running cost of banks, a reasonable profit must be made to carry to the reserves and payment of dividend to the shareholders.

Banks, therefore, grant advances for those transactions, which are on the whole secured and profitable for the bank.

Spread of Risks – Diversification

Another important principle of good lending is the diversification of advances. An element of risk is always present in every advance, however, secure it might appear to be. To safeguard the bank's interests, a banker follows the principles of 'spread of risks' based upon the maxim 'Do not keep all the eggs in one basket'. It means that a banker should not grant advances to a few big units only and should spread the risks involved in lending over a large number of borrowers, over a large number of industries and areas and over different type of securities.

Purpose

While granting loans, a banker must ensure that the purpose of loan should be productive so that the, money not only remains safe but also provide a definite source of repayment. A banker must closely scrutinise the purpose for which the money is required, and ensure that the money borrowed for and particular purpose is applied by the borrower accordingly.

Security

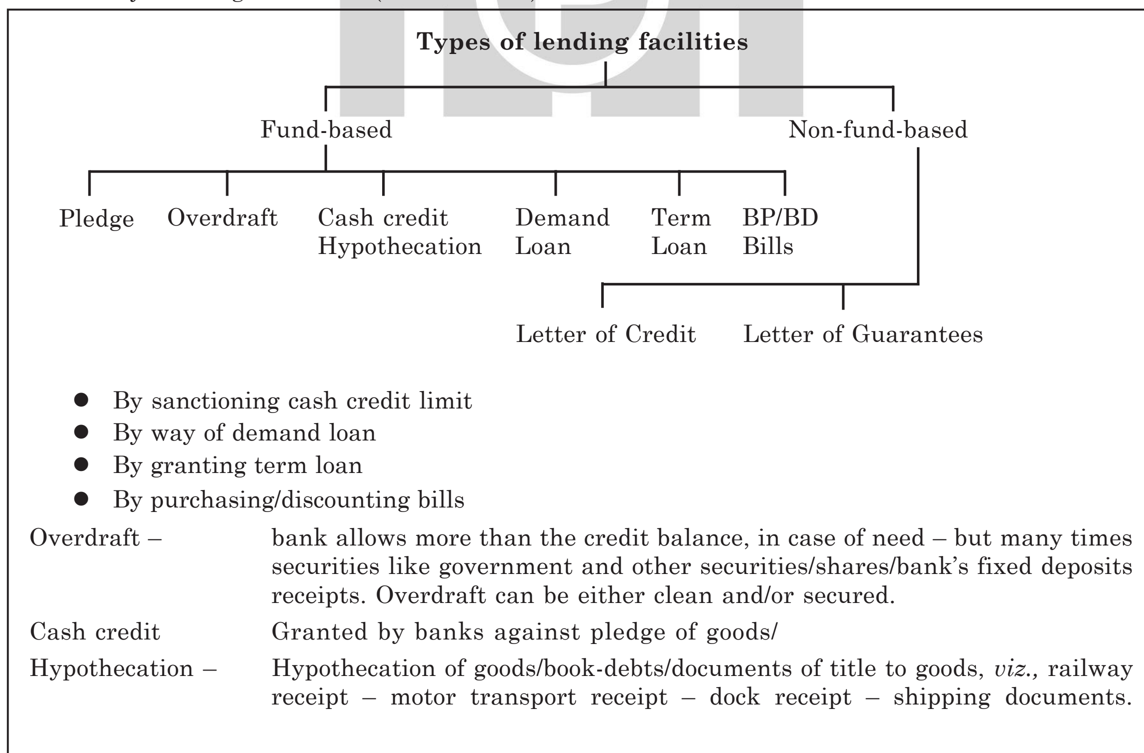
While granting advances banks consider the availability of security as one of the important guiding principles. Security is considered as insurance or a cushion to fall back upon in case of an emergency. Since banks deal in the public money, it is very important to pay proper attention to the security offered against the loan/advance. A good security must have qualities (MAST characteristics) such as Marketability, Ascertainability, Stability and Transferability.

1.10 Types of Credit Facilities

The credit assistance provided by a banker is mainly of two types: One is fund-based credit support and the other is non-fund-based. The difference between fund-based and non-fund based credit assistance provided by a banker lies mainly in the cash outflow. While the former involves immediate cash outflow, the latter mayor may not involve cash outflow from a banker.

Banks may allow fund-based facilities to customer in any of the following manners:

- By allowing overdrafts (clean/secured)



- By sanctioning cash credit limit
- By way of demand loan
- By granting term loan
- By purchasing/discounting bills

Overdraft –	bank allows more than the credit balance, in case of need – but many times securities like government and other securities/shares/bank's fixed deposits receipts. Overdraft can be either clean and/or secured.
Cash credit	Granted by banks against pledge of goods/
Hypothecation –	Hypothecation of goods/book-debts/documents of title to goods, *viz.,* railway receipt – motor transport receipt – dock receipt – shipping documents.

	A fixed credit limit is sanctioned with margin of 25% or above on the purchase price of goods. Withdrawal like in current a/c up to the fixed limit or drawing power (after margin) of the goods whichever is lower. Interest is payable on the daily debit balance and debited on monthly basis. Ownership and possession of goods remain with the owner.
Demand Loan –	Advance for a fixed initial amount loans are for period up to 12 months.
Term Loan –	Advance for fixed period ranging from 3 years to 5 years (except under housing loan which is given up to 30 years) – For acquisition of fixed assets, or – Repayment in equated monthly installments – Painting of financier's name is essential on the fixed asset – Repayment is based on the repaying capacity or income earnings from business.
Purchase/discount of bills	– Purchase of demand or sight bills, Payable on presentation by purchaser of goods. – Interest is recovered from seller/customer at the time of purchase by banks. – On purchase bank becomes holder in due course – (who for consideration becomes the possessor of a promissory note/bill of exchange for cheque. In case of discounting, the repayment to bank comes after the expiry of usance period. – This usance period can be called as credit period.

Overdraft

When a customer, who has a current account, is allowed by the bank to draw more than his deposits in the account, such facility is called an overdraft facility. In this facility, the customer is permitted to withdraw the amount as and when he needs it and to repay it by means of deposits in his account as and when it is convenient to him.

Overdraft is generally granted against government. or other securities, fully paid shares, own fixed deposits, etc. It may also be allowed for short/temporary periods without security in which case the same is known as clean overdraft.

Cash Credit/Cash Credit Merchandise

A cash credit account is a drawing account against a fixed credit limit granted by the bank and is operated exactly in the same manner as a current account with an overdraft facility. Cash credit limits are granted by banks against pledge/hypothecation of goods/book debts/ documents of title to goods, etc., depending upon the nature of requirement of a borrower. Under the system the bank specifies a limit for the customer, up to which the customer is permitted to borrow against the security of assets after compliance of prescribed terms and conditions and keeping prescribed margin against the securities. The customer withdraws from his cash credit account as and when he need the funds and deposits any amount of money which he finds surplus with him on any day. The cash credit account is

thus, an active and running account to which deposits and withdrawals may be effected frequently.

Demand Loan

A demand loan is an advance for a fixed amount and no debits to the account may be made subsequent to the initial advance except for the interest, insurance premium and other sundry charges. Generally, banks provide the demand loan for periods not longer than 12 months.

Term Loan

A term loan is an advance for a fixed period to person engaged in industries, business or trade for meeting their requirements like acquisition of fixed assets like land, building and machinery. Such loans may also be allowed to individuals for the purpose of purchasing houses/consumer durable in which cases the same are termed as housing loans/personal loans, etc. The repayment of term loans may be made in installments which are fixed by the bank taking into consideration the repayment capacity of the borrower. A term loan may be sanctioned for a medium term, (i.e., 3 to 5 years) or for a long-term, (i.e., up to 30 years in case of housing loans).

Purchase/Discount of Bills

Banks may also allow bills purchasing/discounting facility to customer by either purchasing demand bills or discounting usance bills. After purchasing/discounting bills the banker may send the bill for collection of proceeds from the drawee of the bill and on receipt of proceeds the bills are adjusted. In case the bills are not paid by the drawee the banker recovers the amount of the bill and interest thereon from the borrower.

1.11 Non-fund Based Facilities

Banks may allow non-fund-based facilities to customer in any of the following manners:

- Letter of Credit
- Letters of Guarantee

Letters of Credit (LC) or Banker's Commercial Credit

A letter of credit is a mechanism, which helps a trade transaction to be put through between a seller and a buyer. A letter of credit is an arrangement whereby a banker acting on the request of a customer, undertakes to pay a third party, by a given date, according to the agreed stipulations and against presentation of documents, the counter value of the goods and services rendered otherwise. A letter of credit is, thus, an arrangement by which a buyer enables a seller to get the value of the bill of his supplies effected as per agreed terms and on his tendering the stipulated documents of the relative consignment to a banker on or before a given date. The banker after making payment of the bill to the seller presents it to the buyer and obtains payment of it.

Letter of Credit –

- It is an arrangement whereby bank acts on the request of the customer, for making payment to third party
- An undertaking by bank for making payments on presentation of documents
- Seller tenders the documents to bank for payment (and not to the buyer of goods or services)
- Buyer is called LC opener
- Bank is called LC opening bank
- Seller is called the beneficiary of the credit
- LC is either domestic or import
- LC is issued on Documents against Payments (DP) or Documents against Acceptance of bill of exchange

Various Types of LC

- Acceptance credit
- Revocable credit
- Irrevocable credit
- Confirmed credit
- With recourse credit
- Without resource credit
- Transferable Credit
- Back-to-back credit
- Red clause credit
- Green clause credit
- Revolving credit

Letters of Guarantee

- Alternative to case security
- Third party seeks guarantee

  Kinds – Performance guarantee
  – Financial guarantee
  – Deferred payment guarantee (given for payment in various future installments.)
- Statutory guarantee
- Security to bank – Bank's issues guarantees by keeping cash deposits with term, depending on the financial strongness of the customer. It varies form 10% to 100% of commitment amount.
- Period of issue – Guarantees are not issued for unspecified period. It should be specific period
- Commission Payments – Entire commission is recovered from the party, at the time of issue of advance.
- Return of guarantee document, on or before expiry of guarantee period the original guarantee document must be returned to the bank for getting refund of security deposit amount.

The buyer who establishes the letter of credit is known as the opener of LC. The banker who establishes the LC at the request of the buyer is called the LC opening bank and the seller in whose favour the LC is established is known as the beneficiary of the credit. LCs may be issued by banks on DP or DA terms, for import/domestic transactions.

Bank charges commission for the service and the facility rendered/commitment made by him. There are various types of LCs, *viz.,* acceptance credit/irrevocable credit/confirmed credit/ with recourse and without recourse credit/transferable credit/back-to-back credit/red-clause credit/green clause credit/revolving letter of credit, etc.

Letter of Guarantee (LG): In commercial transactions bank's customers are sometimes required to give a bank guarantee. This is mostly as an alternative to keep cash as a security deposit. The bank charges commission for this service, which depends on the security available and the financial stability of the customer. A contract of guarantee is a contract to perform the promise, or discharge the liability (enforceable at law) of a third person in case of his default. Though for the bank issuing the guarantee or indemnity, there is no difference in the type of liability assumed. The bank guarantees may be classified into 4 categories.

(i) Financial guarantees

(ii) Performance guarantees

(iii) Deferred payment guarantees

(iv) Statutory guarantees

(a) Financial guarantees are intended to secure purely monetary obligations. These are issued by banks, on behalf of the customers in lieu of the customer being required to deposit cash security or earnest money. Financial guarantees are bid bond/tender money guarantee/security deposit/advance payment/guarantee given to Court – Custom – Excise or Sales tax authorities.

(b) Performance guarantee is whereby the banks assures a third party that the customer will perform the contract entered into by the customer as per the condition stipulated in the contract, failing which, the bank will compensate the third party upto the amount specified in the guarantee.

(c) Deferred payment guarantee arises in cases of purchase of machinery or such other capital equipment by industries on deferred payment basis. The manufacturer/supplier of machinery supplies the machinery against a down payment of say 10% to 20% of the price and gets us ance bills, for the balance amount in instalments extending over the deferred payment period.

(d) Statutory guarantee issued by banks in favour of courts and other statutory authorities guaranteeing that the customer will honour his commitments imposed upon him under the law, failing which the bank will compensate to the extent of the amount guaranteed. These are usually given in the form of bonds.

1.12 Remittance of Funds

Banks allow funds remittance facilities to their customers enabling theim to remit from one branch to the other or from one place to the other to suit/meet their business/personal needs. For this banks extend services like issue of demand drafts (DD) telegraphic transfer (T.T) and mail transfer (M.T) NIFT/RTGS facilities. Banks charge their commission for this service.

A demand draft is a bank negotiable instrument issued by one branch on another branch, for specific sum of money, payable on demand, for the value received.

Mail Transfer is another type of remittance in which the amount is transferred internally from one branch to another branch for credit to the account of the payee.

Telegraphic Transfer or fax transfer or RTGS is a quicker mode of remittance of funds than through the mail transfer. Electric funds transfer and any branch banking are faster mode of services for remittances. Banks charge higher service charges for these facilities as they loose the benefit of float funds which would have otherwise remained with them in other modes of funds remittance.

Collection and Payment of Cheques: It is the duty of the paying banker to pay the cheque, provided he has in his hands, sufficient funds of the drawer and the funds are properly applicable to such payment and when duly required to do so (Sec. 31 N.I. Act) A banker who has in good faith and without negligence, received payment for a customer of a cheque crossed generally or specially to himself, shall not, in case of the title to the cheque broves defective, incur any liability to the true owner of the cheque by reason only of having received such payment (Sec. 131). We deal some of the essential features as under:

(a) Good faith and without negligence: When the banker receives payment of a cheque to which the customer has no title, the onus is on him to disprove negligence, what amounts to negligence is however, a question of fact in each case. Negligence means want of reasonable care with reference to the interest of the true owner.

(b) Payment of a crossed cheque for a customer: To make a person a customer of a bank it is essential that there must be some sort of account, either a deposit or a current account or some similar relationship.

(c) Collecting bank to receive payment for customer: When the bank acts only as collecting banker (but not a case where banker is himself the holder) the protection is available *(A. L. Underwood Ltd. vs. Barclays Bank (1914).*

(**d**) **Payment is received only for a crossed cheque –** and that crossing has been made before the cheque falls into the hands of the collecting bankers.

If the aforesaid conditions do not co-exist, this protection would be denined to the collecting banker. The protection can be claimed by the collecting banker even when he credited his customer's account with the amount of the cheque before receiving payment thereof.

Agency Functions: Apart from pure banking business of accepting funds in deposits and making advances and investment, a modern bank also provides a variety of ancillary services such as agency services and general utility services. Banks act as agent, when employed by another to do act for another or to represent another in dealing with third person. When the banker collects cheques/bills/promissory notes/dividends or any other instrument on behalf of his customer or buys or sells securities on his behalf, he acts as an agent. The range of such services has now become quite wide. Banks undertake various types of agency functions to increase their earnings and resources. For example, banks in India, are securing agencies for marketing of general/life insurance products and are also entering in the field of marketing of products of various mutual funds.

There are several kinds of agents as per section 182 of Contract Act, 1872. *viz.,*

Attorney/auctioneer/broker/factor/commission agents/counsel/carrier/ship handler or shipmaster/warehouse man.

Agency arrangement with the subsidiaries of the bank engaged in Credit Card/other business is also approved subject to payment of agency commission on total payments at regular intervals.

Banks selectively, accept the work of payment of demand drafts drawn by other bank on few of their branches under agency arrangements, known as draft-drawing arrangements, with other banks. Other agency services are:

(a) issuing/selling on commission and underwriting stock/funds/shares, etc.
(b) collection of bills/hundis/promissory notes/cheques and securities
(c) purchasing and selling of shares/G. P. Notes/bonds/debentures, on behalf of clients
(d) the selling of products of insurance companies/mutual funds
(e) granting and issuing of LC/Travellers cheques/and circular notes.
(f) buying and selling of foreign exchange including foreign bank notes.
(g) contracting for public and private loans.
(h) undertaking and executing trusts.
(i) undertaking the administration of estates as executor/trustee

1.13 Merchant Banking

Merchant bankers are financial intermediaries. They act as intermediaries of transfer of capital from those who own it (Investor or Bond Subscriber) to those who use it [Corporate or Governments.]

Merchant bankers' assist in introducing or selecting or appointing outside technical consultants in addition to in-house technical personnel for preparation of a detailed project report, market survey report, feasibility studies, etc. If the company has already prepared the project report, the viability of the project is seen from the financial angle; effective implementation is carried out by guiding the corporate or government with regards to procedural matters, viz.

(1) Obtaining regulatory clearances such as R.B.I (Reserve Bank of India), S.E.B.I Securities and Exchange board of India), MoF (Ministry of Finance), Stock Exchanges (BSE, NSE) and Registrar of Companies, etc.
(2) Planning and timing of IPO.
(3) Underwriting of IPO by financial institution or brokers. At present major banks act as both merchant bankers and underwriters. But it is not mandatory that all banks acting as merchant bankers to be underwriters.
(4) Selection and appointment of Principal broker and Sub-brokers; with book building now in vogue for IPO, the merchant bankers also help in identifying lead book runners and sub-book runners.
(5) Selecting and appointing the Registrar for Issue and fixing their remuneration.
(6) Selecting and appointing advertising consultants or agencies for publicity campaigns, investor conferences, analyst conferences and road shows.

(7) Writing Red-Herring Prospectus, or "Prospectus" and submitting it for regulatory clearance.

(8) Printing and Distribution of Prospectus and Application forms to Brokers and Sub-Brokers and Book runners.

(9) Making application to Stock Exchanges for listing of the security.

(10) Monitoring and reporting the progress of the offering to the Company and regulatory bodies and other stake holder (if any).

1.14 Lease/Hire Purchase Financing

This means leasing out the capital purchase of assets to another company against monthly rents for assets consumption or use.

Here the finance is arranged by the institution which does not enjoy its use called Lessor. Lessor is entitled to write of a large amount of capital cost against its taxable profits until it is suspended. While the Lessee is benefited in not investing for capital cost plus lease expenses are permitted as revenue expense in the books for Lessee.

The Lease can also be arranged, on any existing freehold asset's or long leasehold property by either mortgaging it or by selling it at Market Price to a leasing company; this leasing company in turn would lease it back to seller of the asset on lease thus benefiting both. In a lease the hirer of the equipment will not become the owner there of.

(A) Advantages to Lessee

1. Use of asset without incurring the capital cost thus saving on cost benefit of capital use.
2. As lease rentals are permitted as a permitted business revenue expense, they lead to depricision in profits and ultimately less taxation on profits.
3. Since there is no Capital Cost, this does not impact the liability side of the balance sheet too.
4. Credit worthiness of the Lessee is intact if Lessee approaches a financial institution, for other credit related facilities.

(B) Disadvantages to Lessee

1. Ownership of the asset is with the Lessor and not with the lessee.
2. Since Lessor imposes usage terms and conditions on assets, asset is permitted to be used for agreed business purposes only; this takes away the leverage from Lessee for utilizing the asset for alternative business purposes (if any).
3. Confiscation or repossession of asset by Lessor on breach of terms and conditions of use of asset.
4. Possibility of Lessor (Owner) becoming insolvent or going into liquidation; thus in such a scenario the asset may be attached by he creditor official Liquidator.

1.15 Factoring Services

Factoring is an arrangement between a Factor usually a bank or NBFC or (Bank Subsidiary) and his client which includes at least 2 of the following services to be provided by the factor:

1. Finance/Maintenance of Accounts and/or
2. Collection of Debts and/or
3. Protection against credit risk.

This brings us to the basic question of what is the difference between the traditional funding options like bill finance and Factoring. Let us distinguish the same using the example of Bill Finance v/s Factoring.

Both Bill finance and factoring are facilities aimed at augmenting the cash flow position of the seller almost similar to availability of working capital at post sales stage; however the approach and operational mechanisms are different between the two concepts.

1. Bill finance provides finance to the entrepreneur while factoring is an ideal tool for growth and development of expanding SMEs (Small and Medium Enterprise).
2. Advances (Loan) are given against bill of exchange whereas in factoring there is an out-right purchase of trade debts after providing for returns, allowances and settlement discounts.
3. In Bill Finance, registration of charge under section 125 of Companies Act 1956 is mandatory for corporate clients whereas in factoring the factor is the owner of trade debts and no registration is payable.
4. Bill financing is individual transaction oriented, while factoring follows the principles of "Whole Turnover" meaning bulk finance against several unpaid trade generated invoices.
5. Bills financed are On Balance sheet items, and are listed in Current Assets in Balance sheet whereas factoring is an off-balance sheet, as the client company completes the double entry accounting by crediting the factor for the consideration value.

When simply put, factoring is receivable discounting, and like all other structured financing deals, factoring also could be with recourse or without recourse.

Advantages of Factoring

1. The distinct advantage of factoring is that the client need not undertake any responsibility of collecting the dues from the buyer thus saving costs on various fronts like maintaining of sales ledger/supervision, etc.
2. Upfront discounted value up to 80% to 85% is available to client on the basis of invoices and the balance retention i.e., 15% to 20% is paid on realization of receivables.
3. Providing expert credit and other business related advise to clients. Ready availability of information regarding product design or mix or prices or market conditions or economic prospects or all.

Disadvantages/Limitations

1. It may result in over-aggressiveness in the behavior of the client resulting in over trading or mismanagement.
2. Possible fraudulent act in furnishing the invoice e.g. non-existent goods or preinvoicing or duplicate invoicing.

3. Lack of necessary skills and professionalism at Factors.
4. Factoring may be an un-viable source of cash flow to SMEs due to higher costs on account of lesser turnover.
5. Companies having large number of debtors for small amounts.
6. Companies with speculative business or companies with weak management or high bad debts dispute/litigation experience.

1.16 Terminal Questions

1. Define the basic concept of banking.
2. Discuss the permissible business which a bank can do in India.
3. There are certain prohibited businesses which are not allowed to be done by banks. Discuss.
4. Explain the reasons for need for bank services in the percent situations.
5. Elaborate the history of banking in India in brief.
6. Define the main functions and other services of a commercial bank.
7. Differentiate current deposits with saving and fixed deposits.
8. Distinguish between Prime Lending Rate and Base Rate.
9. Explain the various principles of sound lending.
10. Discuss the various types of credit facilities allowed by a commercial bank.
11. Differentiate between Fund-based and Non-fund based facilities which are allowed by any bank.
12. What is a letter of credit? Discuss its features.
13. Letter of Guarantee and letter of credit as the same thing. Do you agree? If not why?
14. Do the banks provide funds remittance facility to account holders? How is this provided by banks?
15. Negotiable instrument Act, 1881 states the collection and payment of cheques what are its essential features?
16. Do the banks provide any agency functions? Discuss these agency services.
17. Write short Notes on –
    (i) Merchant banking
    (ii) Lease hire purchase financing
    (iii) Factoring
18. Explain the history of the origin of banks before economic reforms were brought in India.
19. What are the new challenges before commercial banks from the year 2002 to date?