THEORY AND PRACTICE OF BANKING IN INDIA (DBFM04)

(PG DIPLOMA)

ACHARYA NAGARJUNA UNIVERSITY

CENTRE FOR DISTANCE EDUCATION

NAGARJUNA NAGAR,

GUNTUR

ANDHRA PRADESH

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Lesson 1

EVOLUTION OF COMMERCIAL BANKING

1.0 Objective :

The objective of this Chapter is to trace the origin of commercial banking in the early times of human history and evolution of banking in olden times. This chapter also explains the starting of modern banking in India, Nationalisation of banks, Progress of banking in pre-nationalisation period and post nationalization period.

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1.1 INTRODUCTION

Commercial Banks play an important role in directing affairs of the economy in various ways. As a matter of fact the operations of Commercial banks record the economic pulse of the country. The size and composition of their transactions mirror the economic happenings in a country. Long back the well known 19th century economist David Ricardo had stated that a bank was a dealer or transactor in money in a financial system (sayers) It is the banks who set the tempo of aggregate economic activity in any economy.

1.2 Banking in Ancient Times:

Opinions differ as to the origin of the work "Banking". The word "Bank" is said to be of Germanic origin, cognate with the French word "Banque" and the Italian work "Banca", both meaning "bench". It is surmised that the word would have drawn its meaning from the practice of the Jewish money changers of Lombarbdy, a district in North Italy, who in the middle ages used to do their business sitting on a bench in the market place. Again, the etymological origin of the work gains further relevance from the derivation of the word "Bankrupt" from the French word "Banque-

route" and the Italian word "Banqua-rotta" meaning "Broken bench" due probably to the then prevalent practice of breaking the bench of the money- changer, when he failed.

Banking is as old as the authentic history and origins of modern Commercial Banking are traceable to ancient times. The New Testament mentions about the activities of the money- changers in the temples of Jerusalem. In ancient Greece, around 2,000B.C. the famous Temples of Ephesus, Delphi and Olympia were used as depositories for peoples' surplus funds and these great temples acted as the financial agents until public confidence and by transfer orders are found in Assyria, Phoenicia and Egypt before the system attained full development in Greece and Rome. Revipout, a French writer mentions about the banks in 600 B.C. In India also the business of money lenders was found in Manu Smriti. In Egypt also records found about the existence of banks in early days. Banking in its simple form, is as old as the authentic history is. As early as 2000 B.C., Babylonions had developed a system of banking. They used to deposit their valuables in temples. The priests were regarded as custodians or financial agents. This could not last long, since with the spread of irreligion and the ever growing disbelief in moral and spiritual values, public confidence was shaken.

In India the ancient Hindu scriptures refer to the money-lending activities in the vedic period. In India during the Ramayana and Mahabharatha eras, banking had become a full fledged business activity and during the smriti period which followed the vedic period and epic age the business of banking was carried on by the members of vaish community. Manu, the great law-giver of period performed most of those functions which banks perform in modern times, such as the granting loans to kings in times of grave crises, acting as the treasurer and banker to the state and issuing and managing the currency of the country.

Banking existed in India as we have seen earlier in one form or the other from times immemorial. We have got evidence to suggest a few centuries before Christ India had a system of banking which admirable suited her needs. There were bankers in all important trade centres. They performed the usual functions of lending moneys to traders and craftsmen and sometimes placed funds at the disposal of kings for financing wars. Most of the loans were on an unsecured basis but pledge of movables and mortgage of immovable was not unknown. From the laws of Manu the great Hindu Jurist, it appears that deposit banking in some form was known in India in ancient times. Rules and rates relating to deposits and advances were laid down. Hundis and indigenous bills of exchange came into use about the 12th century A.D. The indigenous bankers not only lent money (though known as far bank as the Hindu Era) was issued and the indigenous bankers added one more line of money-changing to their already profitable business. They started exchanging money circulating in one part of the county with the money current in another part of the country, making a good marginal for themselves. The indigenous bankers could not, however, develop to any considerable extent the system of obtaining deposits from the public, which today is an important function of a banker.

In the middle ages also in Europe the Governments used to borrow money from finance companies. For this purpose the First bank called the Bank of Venice was established in 1157. It was the first ancient bank in the world. It was in 12th century that banks on modern lines were established in Europe for the first time. Next bank was existed in Florence in 1336 itself. Later the banks like Barcelona Bank in 1401, Bank of Genoa is 1407 and Bank of Amsterdam in 1609 came into existence in Europe.

In ancient Greece and Rome, practice of granting credit was very much prevalent. Greeks organised some State banks, while Romans regulated private banking minutely, so that it infused public confidence. In Rome, bankers were called Agrentaril, Mensaril or Colly-bistoe. They used to transact the business on similar lines as those of modern banks. Banks received deposits and lent money. People settled their accounts with their creditors by giving a cheque or draft on bank.

For the first time, Bank of Amsterdam issued a certificate to its depositors. With this, the deposited amount was allowed to withdraw within 6 months. Gradually this system was transformed into modern cheque system. It is interesting to note that most of European banks now in existence were formed on the model of Bank of Amsterdam.

1.3 Banking in England:

Modern banking had its beginnings in England in the establishment of the Bank of England in 1694. Up to 1640, the merchants of London used to deposit their monies in the Mint in the Tower. In that year, Charles I seized £ 1,30.000 bullion and cash belonging to merchants. From that date, the merchants used to deposit their funds with the goldsmiths, who, for purposes of their own trade, had facilities for the safe keeping of valuables. It was customary for the goldsmiths to grant receipts for the sums they received. Whenever a depositor withdraws a part of his deposit, the amount so withdrawn was written across the face of the receipt. These receipts were the parents of the bank notes.

Gradually the goldsmiths grew in number and importance. They acted as bankers to the Government and from time to time advanced money to them. By 1672, the Government were indebted to them to extent of £ 1,30,000. This money was not paid and this shook public confidence. From that time the demand grew for the establishment of a bank under a Royal Charter. In fact various attempts were made for the starting of a central bank from 1621, but with no success.

The Bank of England was established in 1694 under a Royal Charter. The Scheme of the Bank of England was suggested by a Scotchman William Paterson, and was put into effect by then Chancellor of Exchequer with conspicuous success. The Bank was to raise a capital of £ 1,200,000, the whole of which was to be lent to the Government at 8 per cent plus £ 4,000 a year towards expenses of management. The Bank was empowered to issue notes to the full extent of its loan to the Government, but not beyond. The loan was to be repaid at the expiration of 12 years- the period of which the Charter was in the first instance granted. Actually, however, the Charter was periodically renewed a fresh loan being granted to the Government at the time of each renewal. The Act of 1844 extended the Charter for an indefinite period. The Government loan stands at present at £ 11,015,100.

The Bank of England was a Whig scheme and its success induced the Tories to try to establish a similar bank. Their attempt, however, ended in a failure. This led to the passing of the Act of 1708, which forbade the establishment of any bank with more than six members with the right to 'borrow, owe or take up any sums of money on their bills or notes payable on demand or at a less time than six months from the borrowing thereof'. This Act did not forbid the establishment of banks as such; it only forbade them to issue notes. But the note-issue function was considered in those days indispensable to banking that no attempt was made to establish another bank with more than six members, until 1826 when the Act of 1708 was modified. The Act of 1708 thus gave the Bank of England a good start which accounts for its unique position among the banks of

England. Further, the Bank of England was the Government banker and on account of its predominance in the London Money Market, it has grown into the central bank of the country.

1.4 Evolution of Banking in India:

Although evidence regarding the existence of money lending operations in India is found in the literature of the vedic times i.e., 2000 to 1400 B.C., no information is available regarding their pursuit, as a profession by a section of the community till 500 B.C. From that time onwards, India possessed a system of banking, which fulfilled her needs, although its methods differ from those of modern Western banking. Banking on Western lines had started since 300 years only.

It seems that the first modern bank was set up in 1688 in Madras. Next one was started in 1724 in Bombay. Banks could be regarded as an outstanding contribution of the British rulers to promote of their trading interests. The British came to India for purposes of trade, but in the course of a century and a half the flag, as goes the saying, followed trade and they became the rulers of the country. It was only in their interests that the banks were established, the first joint stock bank being, The bank of Hindustan in 1770 in Calcutta, as an appendage of one of the British agency, M\s Alexander & co. This bank was failed in 1832. But , later many banks like general bank of Bengal and Bihar in 1773, Bengal bank in 1784 and general bank of India 1786 were formed in Calcutta and they failed in 1775, 1791 and 1991 respectively. The present era in Banking may be taken to have commenced with the establishment of Bank of Bengal in 1809 under the Government charter and with Government participation in the share capital. Bank of Bombay and Bank of Madras commenced their operations in 1840 and 1843 respectively, on similar lines. These three banks were known as the presidency Banks. They were also given powers to issue notes and thus could be regarded as quasi- central Banks, too. Since their notes did not become popular these power were withdrawn in 1862. Subsequently, these three banks were merger together to form imperial bank of India in 1921 which was nationalized in 1955 and named as State Bank of India.

In fact, after this period there was virtually a mushroom growth of Banks from the year 1860, Joint stock banks with limited liability made their appearance on the banking scene. Allahabad bank Ltd was established under European management in 1865; The Punjab National Bank Ltd, was founded in 1895; The Bank of India Ltd. And Canara Bank Ltd, in 1906; The Indian Bank Ltd. In 1907; Bank of Baroda Ltd. In 1908; Central Bank of India Ltd. In 1911 and Union Bank of India Ltd. in 1919.

Other major commercial banks that were established in India during this period and which could not unfortunately survive for a long time were Indian Specie Bank, Bengal National Bank, Credit Bank of India, Bombay Merchants Bank, Standard Bank of Bombay and Bank of Upper India.

Indian banking system experienced a series of crises and as a consequence, it witnessed a number of bank failures. This is more so during the period of post World War I. For instance, as many as 161 banks with Rs.7 crores of paid-up capital failed during 1913-1914. Hence inspite of the establishment of a considerable number of new banks in the country, growth of banking was quite slow and unstable during first quarter of 20th century.

For regulating banking system in India, for bringing about co-ordination between different banks in the country and to act as a banker to Government, Reserve Bank of India was started in

1935. Thus by 1947, when the country got political Independence, there were 648 commercial banks with, 4,819 branches in India. The other banks are started after RBI are Andhra Bank Ltd. In 1936; Dena Bank Ltd. In 1938; United Commercial Bank Ltd. In 1943; and United Bank of India Ltd. In 1950. All these banks have branches in many important centres of the country. Some of them do have offices in foreign countries as well. These commercial banks undertake all types of banking business including deposits, advances. Collection and purchase of bills, remittances and foreign exchange.

Soon after Independence, Government of India decided to regulate and reform banking structure. As a consequence Reserve Bank of India was nationalized in 1949. Nationalisation of R.B.I was followed in quick succession by enactment of Banking Regulation Act, 1949 (originally called as Bank Companies Act, which changed its name as Bank Regulation Act in 1965). As stated earlier, Imperial Bank soon after its nationalization in 1955, took up the affiliation of 8 State Associated banks, which were nationalized under S.B.I. (Subsidiary Banks) Act, 1959.

The Government of India therefore, with effect from 19 July 1969 [By an ordinance issued on that date] nationalised 14 major banks, each with an aggregate deposit of Rs.50 crores or more with a view to “ to serve better the needs of development of the economy, in conformity with National Priorities an Objectives.

The following were considered to be the compelling reasons for the Bank Nationalisation:

1. Concentration of wealth and economic power in industrialists an businessman:
2. Branch expansion was confined only to urban areas with rural areas being neglected;
3. Sectors like agriculture, small scale industries an the other deserving sectors were outside the purview of the lending operations of the bank;
4. Various mal practices indulged in by banks under private ownership and management to favor big businessmen and industrialists and
5. To give a re-orientation in attitude and outlook of the bankers so as to make them conscious of social objectives and to make them embrace social banking.

Banks are today on integral part of our every day life. The significance of banking in our day to day life is being fell increasingly. Forms of money evolved from coins to paper notes to credit cards. Commercial transactions have increased in content and quantity from simple barter to speculate international trade. Hence a need arose for a third party who will assist smooth handling of transactions mediate between seller and buyer hold custody of money and goods, remit funds and also collect proceeds. He was the banker.

The banking industry in the Country has been grown into gigantic proportions with particular emphasis on improving the living standards of people in rural areas. The weaker sections of the society have been richly benefited by the various schemes; fulfilling the objectives of nationalization of banks.

Commercial banking in the Country is under going rapid transformation at one side to integrate with the process economic planning and growth with expended activities with social banking etc., and on the other hand is playing a vital role in mobilization of resources.

The history of banking development in India since independence is a notable example of the successful orientation of commercial banks to the growing needs and complexities of development. The present structure is the out come of a process of expansion, re-organisation and consolidation. The Banking system went through two phases of development in the pre-

nationalisation period and post-nationalisation period. Now it has entered a third phase of development market by innovation and diversification into new areas of financial services.

1.5 Pre-Nationalisation Period:

Commercial banking as it had developed in India prior to independence was based in the British Banking pattern of branch Banking providing basically short-term finance to trade and industry. The bank net work was small and mostly concentrated in cities and port towns. District after districts were without any branch of Commercial Banks. Rural areas where 80 per cent of the populiar resided, were basely touched by there branches. Agriculture which contributed more than half of the domestic product and provided lively hood to more than ¾ of population remained neglected by Commercial banks.

India inherited in 1947 an economic and Financial system conditioned by the limited horizon of the then Government economic policy. Soon after independence, the RBI was nationalized in 1949 as promised by the Government that the Central Banking should have the Commitment to secure the social and economic objectives of the country. Under the Banking Regulation Act 1949, the RBI has acquired extensive powers of supervision and control over the banks. The RBI has adopted a policy of mergers and amalgamations of weak and small banks and the total number of banks were reduced from 500 in 1951 to 89 in 1969. in 1955 the Imperial Bank of India was converted as State Bank in India and in 1959 the State associated banks were converted as subsidiaries of SBI. The Banking System was recognised as an instrument of economic growth and the banking system was regulated to curb concentration of economic power and encourage judicious use of resources for financing development activities.

1.6 Scheme of Social Control:

The scheme of social control of Banks was introduced by the Government on December 14,1967, when the Finance Minister Morarji Desai made a statement in the Lok Sabha while explaining its objectives and main features on functioning.

The important objectives of Social Control of Banks were supposed to be:

i) To strengthen the banking system by preventing bank failures and thus to sustain public confidence in banking and to promote the growth of banking on sound lines.
ii) To produce a uniform and all-round development of the banking structure by appropriate expansion, co-ordination and integration of all allied banking institutions.
iii) To check concentration of economic power through equitable distribution of bank credit.
iv) To stress the need for extending banking services to the rural sector.
v) To make bank finance available for essential productive purposes in priority sectors such as agriculture, small-scale industries and exports.
vi) To make the banking system reorient its functioning, expansion and Credit allocation in line with plan requirements for facilitation rapid economic growth and achieving the ideals of a socialist pattern of society.
vii) To impart greater flexibility and maneuverability to the monetary and fiscal measures.

Steps towards Social Control:

Several steps had been instituted by the Government for exercising Social Control over banks with the objective of making banking more purposeful, more dynamic and more helpful to the common man. First of all, a National Credit Council at an all-India level was established

in December 1967, for this purpose. It was basically designed as an instrument of credit planning. The National Credit Council consisted or representatives from large, medium and small scale industries, agriculture, Co-operative Sector, trade and bankers and professional accountants. The Finance Minister was its Chairman and the Governor of Reserve Bank, Vice-Chairman. The N.C.C. began to function from February ,1968. The main functions of the N.C.C. were:

i) To assess the demand for Bank Credit from different sectors of the economy.
ii) To lay down priorities for granting loans and advances for investment, considering the availability of resources and the requirements of the priority sectors, in particular, agriculture small scale industry and exports.
iii) To co-ordinate lending and investment policies as between different financial agencies with a view to ensuring an Optimum and efficient use of the over all resources and
iv) To tackle other related issues as may be referred to it by the Chairman or the Vice-Chairman of the Council.

Obviously, as the planner of Credit, the N.C.C. had to see to it that Credit was not given to influential sections, i.e., bigger industrialists, but to all those who were in real need of it, on the basis of certain priorities. The banks were supposed to adhere strictly to the execution of credit policies, plans and directions specified by the N.C.C.

Secondly, the legislative measure for Social Control of banks was introduced by enacting the Banking from February 1, 1969. Under the Social Control Scheme, the Boards of Directors of Banks were to be reconstituted. According to the new Act, not less than 51 per cent of the total number of members of the Board of Directors of a Bank had to consist of persons who have specialized knowledge or practical experience in accountancy, economics, banking agriculture and rural economy, co-operation, finance, law and small scale industry. Further each bank was supposed to have a professional banker and not an industrialist as its full time Chairman.

The Reserve Bank was however, empowered to appoint, remove or terminate the services of the Chairman, any director, the Chief Executive Officer or any other officer or employee of a bank, under specific circumstances. The new Act also specified that all Foreign banks were to set up an advisory board consisting of Indians and conduct their lending policies and activities under the guidance of such an advisory board. Above all, the new Act also empowered the Government to take over (nationalize) any bank in the country, without resorting to legislation , in the interest of depositors and better provision of credit.

Thirdly, under the Scheme of Social Control, advances, and guarantees to directors and their concerns were prohibited in order to eliminate favouritism.

Fourthly, in order to enlarge the Commercial banks role in agricultural finance, the Agricultural Finance Corporation Limited was set up in 1968. It was a joint organization of the leading Commercial banks actively working for the development of agricultural sector.

Finally, the RBI also introduced changes in its branch expansion policy, as guided by the N.C.C. for extending banking facilities to wider areas.

1.7 NATIONALISATION OF 14 COMMERCIAL BANKS:

Following the introduction of the Scheme of Social Control , the tempo of branch expansion no doubt accelerated substantially. The number of bank offices went up by 665 during the first year (1968) of Social Control and no fewer than 785 new offices were opened during the first six months of 1969. But there was no significant reorientation of the lending activities of banks so as to ensure that the legitimate Credit requirements of priority sectors and weaker sections were adequately met.

In many banks, people who had been controlling their policies in the past continued to exercise their influence over them in one way or another, sometimes by the continued presence of the old Chairman or Vice-Chairman on the boards of the banks. Even the directions issued by the Government were not followed by many of the banks. Advances to priority sectors as of June, 1969 amounted to just Rs.500 crores (covering barely 2.6 Lakh accounts), constituting not more that 14 per cent of gross bank Credit. Agriculture accounted for Rs.190 crores, small industries for Rs.280 crores and all other priority sectors put together (Road, Water, Transport Operators, retail trade/small business, professional/ self-employed and education) for Rs.30 crores. It was felt that Social Control was not sufficient to make the Commercial banking system a meaningful instrument of Soci0-Economic policy.

The Government was, therefore left with no choice but to nationalize the commercial banks in order to channelise their resources for balanced economic development of the Country. Accordingly, on 19 July 1969, the Government of India promulgated an ordinance, called the Banking Companies (Acquisition and Transfer for Undertakings) ordinance, 1969, in terms of which the Central Government acquired the Undertakings of 14 biggest Commercial banks incorporated in India which had deposit of not less than Rs.50 crores each. These 14 banks, with a total paid-up capital of Rs.28.5 crores had 4,134 branches, deposits of Rs.2,626 crores and advances of Rs.1,813 crore. Table 1 furnishes the details of those banks as on 19 July, 1969.

1.8 OBJECTIVES OF NATIONALISATION OF 14 COMMERCIAL BANKS:

The Six-fold objectives of nationalization of 14 banks as set out by the former Prime Minister, late Smt. Indira Gandhi were:

i) Removal of Control by a few.
ii) Giving of Professional bent to Bank Management.
iii) Encouragement of new classes of entrepreneurs and

Table 1.1
Branches, Deposits and Advances of 14 Commercial Banks Nationalised on 19th July, 1969.

(Rs. In Crores)

Banks	Branches (Nos.)	Deposits (Rs.)	Advances (Rs.)
Central Bank of India	564	442	303
Bank of India	274	358	243
Punjab National Bank	570	358	257
Bank of Baroda	373	283	257
United Commercial Bank	349	203	136
Canara Bank	325	148	109
United Bank of India	175	147	107
Dena Bank	234	125	76
Union Bank of India	241	115	74
Allahabad Bank	153	114	82
Syndicate Bank	307	110	90
Indian Bank	218	79	60
Bank of Maharashtra	153	78	55
Indian Overseas Bank	198	67	45
Total:	4,134	2,626	1,813

Source:

Range Swamy B., Public Sector Banking in India, Publication Division, Ministry of Information, and Broad Casting, Government of India.

iv) Provision of adequate training as well as reasonable terms of service for bank staff.

v) Elimination of the use of Bank Credit for speculative and unproductive purpose, particularly to the extent that it is encouraged by the association of a few leading groups with some of the major banks.

vi) Expansion of credit of priority areas which come hither to some what neglected such as agriculture and industry, as also for export.

The nationalization of 14 Commercial Banks marked the most important land mark in the history of Indian Banking. Accounting for 50 per cent of total commercial bank offices, 83 per cent of deposits, and 84 per cent of advances table 2 presents the position of public sector banks Vis-à-vis private sector banks as on 19th July, 1969.

After the take over, the undertaking of each of the 14 banks including its assets, liabilities, rights etc., was transferred to and vested in the

Table 1.2

BRANCHES, DEPOSITS AND ADVANCES OF PUBLIC SECTOR BANKS VIS-À-VIS PRIVATE BANKS IN INDIA AS ON 19TH JULY, 1969.

(Rs. In Crores)

Public Sector Banks	Branches (Nos)	Deposits (Rs.)	Advances (Rs.)
S.B.I.	1,569	948	966
S.B.I. Associates	893	291	219
14 Nationalsied Banks	4,134	2,633	1,850
Private Sector Banks	1,666	774	574
All Commercial Banks	8,262	4,646	3,609
% Share of Public Sector Banks in Total	79.8%	83.1%	84.1%
%Share of 14 Commercial Banks in total	50%	56.7%	51.3%

Source:

RANGA SWAMY, B., Public Sector Banking in India, publication Division, Ministry of Information and Broad Casting, Government of India.

Corresponding new bank which became a new statutory corporate body. The general Superintendence and direction of the affairs of each bank was vested in a custodian who was authorized to exercise all powers that might be exercised by the bank. The chairman of each of the nationalized banks who was holding office as such immediately prior to nationalization was appointed as Custodian for Corresponding new bank. A bill to replace the ordinance was introduced in Parliament on 25th July,1969 and was passed by both the houses and became an Act on 9th August, 1969. Following the declaration of the Act as void by the Supreme Court, a fresh ordinance was issued on 14 February, 1970 under which the Government again took over the undertaking of each of the 14 banks with effect from the original date, that is 19th July, 1969. The Banking Companies (Acquisition and transfer as under takings) Bill replace the ordinance was introduced in Parliament on 27 February, 1970 and was passed by both the House towards the end of March, 1970; it received the assent of the president on 31st March,

The Central Government was authorized to draw up Scheme, after consultation with the Reserve Bank of India, for carrying out the provisions of the Act which might provide inter-alia, for the constitution of Boards of Directors of the corresponding new banks, their capital structure, reconstruction and amalgamation. The Statue prescribed that each Board of Directors would have to include representatives of employees and depositors of the Bank and such persons as might represent the interest of farmers, workers and artisans. The Government was also empowered to issue nationalized banks directives on matters of policy involving public interest after consultation with the Governor of the Reserve Bank of India, having regard to responsibilities revolving on the Custodians in the absence of Board of Directors.

The Reserve Bank issued a statutory direction of 22nd January, 1970 requiring each of the 14 banks to obtain its prior approval before putting through certain transactions. Important among these transactions were grant of excess type of advances in excess type of advances in excess of Rs.25 Lakh, investment in excess of Rs.1 Lakh in shares and debentures of joint stock companies

or advances against them were above Rs.5 Lakhs, appointments and extension of services of senior executives and expenditure on land buildings above specified amounts and making provisions out of profits for 1969. on 18th July, 1970 the Central Government, in consultation with the Reserve Bank, constituted the First Boards of Directors for all the nationalized banks.

The board aims at nationalization of banks as stated in the preamble to the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 were "to control the heights of the economy and to meet progressively and serve better the needs of development of the economy in conformity with national policy on objectives". It would be the endeavour of the nationalized banks to ensure that the needs of productive efforts of diverse kinds irrespective of size and social status of the borrower and, in particular, those of farmers, small scale industries and self-employed professional groups were met in an increasing measure. It would also be a primary objective of nationalised banks to faster actively the growth of new and progressive entrepreneurs and to create fresh opportunities in backward areas in different parts of the Country.

1.9 Nationalisation of 6 Commercial Banks:

With a view to enhancing the ability of the banking system to meet more effectively the needs of the development of the economy and the promoting the welfare of the people more adequately, six more banks in the private sector banks each with demand and time liabilities in India of not less than Rs.200 crores were nationalized on 5th April, 1980. The six banks were the Punjab & Sindh Bank, Andhra Bank, New Bank of India, Vijaya Bank, Oriental Bank of Commerce and Corporation Bank. They together had 2,686 offices, with deposits of Rs.2,110 crores and advances of Rs.1,375 crores as on the last Friday of March, 1980.

With the nationalization of the above banks , the number of public sector banks excluding regional rural banks increased to 28, comprising the State Bank of India seven S.B.I. Associate Banks and 20 nationalised banks. They accounted for 91 per cent of the total deposits and advances of commercial banks, it was 84 per cent previously.

Table 1.3

BRANCHES, DEPOSITS AND ADVANCES OF 6 COMMERCIAL BANKS ON 31ST MARCH, 1980.

(Rs. In crores)

Bank	Branches (Nos)	Deposits (Rs.)	Advances (Rs.)
Punjab and Sindh Bank	520	466	336
Andhra Bank	588	460	308
New Bank of India	402	391	237
Vijaya Bank	571	365	208
Oriental Bank of Commerce	301	216	152
Corporation Bank	304	212	134
Total :	2,636	2,110	1,375

Source:Ranga Swamy B., Public Sector Banking in India, Publication Division, Ministry of Information and Broad Casting, Government of India.

As explained above, the major objectives of nationalization of banks were widening of the branch network of the banks particularly in rural and semi-urban areas, greater mobilization of saving through deposits, reorientation of credit flow so as to encourage hitherto neglected sectors such Agriculture, Small Scale Industries and small Business. Several Policies/Programmes have been initiated to achieve these objectives. Several institutions and infrastructural facilities have also been formulated for the purpose of achieving these objectives. The more important were:

1. Lead Bank Scheme.
2. Regional Rural Banks.
3. Priority Sectors Lendings.
4. Rural Development Schemes.
5. Poverty allevation Programmes in rural and Semi-urban areas like D.R.I. and SEPUP.
6. Self-Employment Schemes-SEEUY, TRYSEM, NREP.
7. Command Area Development Schemes.
8. Village adoption schemes.
9. Establishments of NABARD,
10. Adoption of Service Area Approach.

1.10 Progress of Banking in India in Pre-nationalisation:

The services which are rendered by modern banks were rendered by some individuals, agencies and communities even in the Vedic period. References of full fledged banking are found in Ramayana and Mahabharata also which show that during those days also banking was reasonably developed in India. Banking business which was a side business during vedic period became a full time business during Ramayana and Mahabharata.

During Smriti period, which followed the vedic period, and the Epic age, Vaishya Community was rendering the services of modern banking. It may, therefore, be said that Vaishayas are the fore-fathers of modern banking. It may therefore, be said that Vaisyas are the fore-fathers of modern banking in India. These individuals or firms engaged in banking business were known as indigenous bankers.

<u>"Indian Banking Industry(1939-1948)":</u>

Thus, the growth of Indian Banking Industry from that of the indigenous bankers to that of the setting of individual banks is seen during the period.

Table 1.5

BANKING INDUSTRY IN INDIA DURING 1939-1948

(Rs. In crores)

Items	1939	%	1940	%	1941	%	1942	%	1943	%	1944	%	1945	%	1946	%	1947	%	1948	%
1.Number of Banks																				
(a)Imperial Banks	1	-	1	-	1	-	1	-	1	-	1	-	1	-	1	-	1	-	1	-
(b) Scheduled Bank	39	-	41	-	44	-	44	-	57	-	69	-	75	-	77	-	80	-	77	-
© Non-Scheduled banks	643	-	592	-	415	-	431	-	489	-	559	-	646	-	542	-	554	-	541	-
Total	683	-	634	-	460	-	476	-	547	-	629	-	722	-	620	-	625	-	619	-
2. Paid-up capital and reserves																				
(a) Imperial Banks	1123	39	1125	38	1125	36	1138	33	1148	27	1163	22	1170	19	1180	17	1188	27	1190	16
(b) Scheduled Bank	1194	42	1267	42	1360	44	1625	48	2372	56	3206	60	3877	62	4337	65	4617	66	5004	67
© NonScheduled Banks	548	19	587	02	631	20	667	19	725	17	939	18	1211	19	1182	18	1209	17	1261	17
Total	2865	100	2979	100	3116	100	3430	100	4245	100	5308	100	6258	100	6699	100	7014	100	7515	100
3. Deposits																				
(a) Imperial Banks	8784	43	9603	42	10892	42	16346	42	21453	37	23778	32	25937	28	27167	27	29659	29	28029	29
(b) Scheduled bank	9374	46	10610	47	12904	49	18934	49	32450	55	45657	58	54280	60	61121	62	61987	63	59383	63
© Non-Scheduled Banks	2187	11	2450	11	2494	9	3471	9	4803	8	7560	10	11075	12	10413	11	8332	8	7655	8
Total	20345	100	22663	100	26290	100	38751	100	58706	100	75995	100	91292	100	98691	100	98976	100	95067	100
4. Loans and Advances																				
(a) Imperial Banks	4828	40	3231	32	3888	32	3379	29	4060	23	7023	26	7297	21	9427	21	8915	21	9800	23
(b) Scheduled Banks	5258	44	4895	49	6276	52	6067	52	10893	61	15788	59	22155	63	30467	67	28143	66	27292	64
© Non-Scheduled Banks	1964	16	1854	19	1850	16	2165	19	2778	16	3976	15	5732	16	5871	12	5537	13	5286	13
Total	12050	100	9980	100	12104	100	11611	100	17731	100	26787	100	35184	100	45785	100	42865	100	42378	100
5. Investments																				
(a) Imperial Banks	3802	48	4857	50	6439	50	11641	51	13020	42	14863	38	15418	33	15453	34	16419	35	16125	35
(b) Scheduled Banks	3651	46	4245	44	5852	45	10177	45	16702	54	23208	58	27902	60	27019	59	18485	60	27953	60
© Non-Scheduled Banks	523	6	552	6	652	5	918	4	1123	4	1808	5	3199	7	3416	7	2631	6	2455	5
Total	7076	100	9654	100	12945	100	22736	100	30845	100	39879	100	46519	100	45888	100	47535	100	46535	100

The growth of banking industries in the country from 1939 to 1948 in terms of their numbers, internal resources deposits, advances and investments are reflected in Table.

The table shows that besides, Imperial Bank of India, there were 39 scheduled banks and 643 non-scheduled banks operating in India in the year 1939 while the corresponding numbers were found to be 77 and 541 in the year 1948. It may further be noted that scheduled banks recorded almost a continuous growth during this period, whereas the trend in the number of non-scheduled banks showed a declining trend till 1945. Again during 1946 their number was reduced.

These trends were partly as a result of Reserve Bank of India policy to promote scheduled banks in the country and partly due to the partition of the country in 1947.

Indian Banking Industry (1951-1969):

The highlights of the growth in banking industry in India between 1951 and 1969 are presented in table.

In the year, 1950, as many as eleven banks went into voluntary liquidation while 4 scheduled banks in Bengal were amalgamated with United Bank of India Ltd., and 144 uneconomic offices (branches) of scheduled banks were closed. As such, the total offices of scheduled banks in India declined from 2,411 in 1949 to 2,355 in 1950. The process of amalgamation and liquidation of uneconomic banks and their offices continued even during the planning period. The important events that took place during first five year plan were the declaration of Reserve Bank of India, nationalized on January1, 1949 as the Central Bank of the country in 1955 under the Reserve Bank of India Act, 1934 and the establishment of the State Bank of India in 1955, as the agent of the Reserve Bank of India, under section 45 of the Reserve Bank of India Act,1934.

Table 1.6
BANKING INDUSTRY DURING 1951-1969

(Rs. In crores)

Items	1951	%	1956	%	1961	%	1966	%	1967	%	1968	%	1969	%
1. No. of reporting banks														
(a) State Bank of India	1	-	1	-	1	-	1	-	1	-	1	-	1	-
(b) Scheduled Banks	75	-	71	-	66	-	59	-	57	-	56	-	57	-
© Non-Scheduled Banks	469	-	333	-	210	-	27	-	20	-	73	-	14	-
Total	545	-	405	-	277	-	87	-	78	-	73	-	72	-
2. Paid-up capital & reserves														
(a) State Bank of India	1198	16	1201	17	1383	18	1695	17	1785	17	1887	18	1998	18
(b) Scheduled Banks	4880	66	4814	66	5672	74	7984	81	8284	81	8510	81	8983	81
© Non-scheduled banks	1337	18	1208	17	580	8	213	2	202	2	174	1	160	1
Total	7415	100	7223	100	7635	100	9892	100	10271	100	10571	100	11141	100
3. Deposits														
(a) State Bank of India	23091	28	23547	23	53426	29	78610	23	85840	23	94983	22	11141	23
(b) Scheduled Banks	51734	63	72536	70	124995	79	255899	76	282360	76	323427	77	369347	76
© Non-Scheduled Banks	6977	9	7375	7	39996	2	2460	1	2658	1	2721	1	2439	1
Total	81802	100	103458	100	183239	100	336769	100	370858	100	42112	100	483224	100
4. Loans & advances														
(a) State Bank of India	14247	29	14016	21	25531	23	54068	24	59550	24	75522	26	84136	25
(b) Scheduled Banks	30192	61	47829	72	83586	75	170731	75	189639	76	210977	73	255462	75
© Non-Scheduled Banks	4742	10	4254	7	2506	2	1373	1	1286	-	1371	1	1233	-
Total	49181	100	66099	100	111623	100	226172	100	250475	100	287810	100	340831	100
5. Investments														
(a) State Bank of India	8516	26	10687	26		36	29870	28	31075	27	32245	26	35816	25
(b) Scheduled Banks	21727	66	27043	66		62	77605	72	81772	72	95746	73	108808	75
© Non-Scheduled Banks	2658	8	3195	8		2	887	-	1172	1	1186	1	988	-
Total	32901	100	40925	100		100	108632	100	114019	100	130177	100	145612	100

Source: Compiled from various issues of the statistical tables relating to Banks in India, published by RBI.

As a result of continuous amalgamations and liquidations, there had been a continuous decline in the number of both scheduled and non-scheduled banks during 1951-69, the decline being speeder in the case of the latter as compared to the former, Consequently, the number of Scheduled and non-scheduled banks operating in the country were found to be 57 and 14 only in

the year 1969. It may be mentioned that the seven subsidiary banks of the State Bank of India had also been operating in the country besides the scheduled and non-scheduled banks.

In order to achieve the objects of nationalization several measures were a initiated by Reserve Bank of India viz.,

1. Implementation of the branch lincencing policy with special emphasis placed on opening branches in rural unbanked/under banked areas.
2. Diverting credit of nationalized banks to the identified sectors of economy collectively known as priority sectors by fixing target of 40 per cent of credit with sub-targets for various sub-sectors.
3. Increase the rate of interest on cash Reserve Ratio was increased by RBI to 10.5 per cent (above the bank rate of 10 per cent).
4. Diverting the commercial banks towards non-banking activities like mutual funds, hire purchase and leasing etc.
5. Introduction of new financial instruments like commercial paper certificate of deposits etc.
6. Rate of interest on Food credit was increased form 12.5 per cent to 14 per cent from 1984.

1.11 Progress of Banks in India after Nationalisation

Growth of India banking particularly during the last three and half decades has been phenomenal. All major development indicators posted two digit growth rates during this period.

As per March 2005, total Commercial Banks in India are*. It includes State Bank of India and its subsidiaries 8, nationalized Banks, 19 Regional Rural Banks 196 , Foreign Indian Banks 33,

Table No. 1.7

PROGRESS OF COMMERCIAL BANKING AT A GLANCE

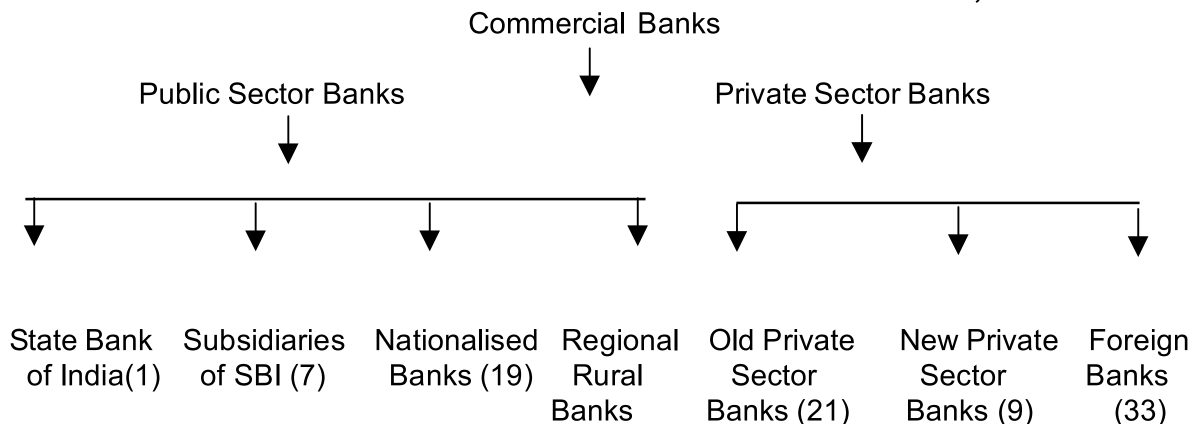
Important Indicators	Jun-69	Mar-02	Mar-03	Mar-04
No. of commercial Banks	89	298	294	291
a) Scheduled Commercial Banks	73	294	289	286
Of Which: Regional Rural Banks	0	196	196	196
b) Non-Scheduled Commercial Banks	16	4	5	5
Number of Bank Offices in India	8262	66190	66535	67188
a) Rural	1833	32380	32303	32121
b) Semi-Urban	3342	14747	14859	15091
c) Urban	1584	10477	10693	11000
d) Metropolitan	1503	8586	8680	8976
Population per office (in thousands)	64	16	16	16
Deposits of Scheduled Commercial Banks in India (Rs.Crore)	4646	1131187#	1311761#	1542284&
Of which; a) Savings	1269	255598	302296	373678
b) Term	2600	759644	877092	985483
c) Current	1304	1125070	164364	203143
Credit of Scheduled Commercial Banks in India (Rs. Crore)	3599	609053	746432	865594
Deposits of Scheduled commercial Banks per office (Rs. Lakh)	56	1709	1972	2295
Credit of Scheduled Commercial Banks per office (Rs. Lakh)	44	920	1122	1288
Per Capita Deposits of Scheduled				

Commercial banks (Rs.)	88	10994	12554	14550
Per Capita Credit of Scheduled Commercial Banks (Rs.)	68	5919	7143	8166
Deposits of Scheduled Commercial Banks as percentage of National Income (at current prices)	15.5	60.7	65.3	68.5
Scheduled Commercial Banks' Advances to Priority Sector (Rs. Crore)	504	205604	250989	316808*
Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks (per cent)	14	34.8	34.6	37.7*
Share of Priority Sector Advances in Total Non-Food Credit of Scheduled Commercial Banks (Per cent)	15	38.2	37.1	39.4*
Credit Deposit Ratio	77.5	53.8	56.9	56.1
Investment Deposit Ratio	29.3	38.7	41.3	43.8
Cash Deposit Ratio	8.2	7.1	6.3	5.6

Source: Basic Statistical Returns of Scheduled Commercial Banks in India , March, 2004.
IBA Bulletin various issues.
@ Includes Resurgent India Bonds (RIB) (Rs.17,945 crore)
# Includes Resurgent India Bonds (RIB) (Rs.17.945 crore) and also India Millennium deposits (IMD) (Rs. 25,662)
& Includes India Millennium Deposits (IMD) (Rs.25,662 crore)
* Provisional

Private Indian Banks 30 (Old Private Sector banks 21 and New Private Sector Banks 9). Besides there are Co-operative banks and an Exim Bank. Population for branch office has decrease from 60,000 in 1969 to 16,000 in 2005. Number of offices had been increase from 9,011 in 1969 to 67,188 in 2005. The Banking Developments during 1969-2004 has been shown clearly in Table No. 1.7.

Total Number of Commercial Banks in India as on 31st March, 2005



A significant transformation of the Indian banking sector took place from 1969. More specialized banks like NABARD, SIDBI, National Housing Bank and RRBs appeared on the scene. One the main objectives of nationalization was to extend the credit facilities to all segments of the economy and also to mitigate the reasonable imbalances in its availability. A series of measures was taken in close succession, enabling the nationalized banks to play an effective role in the

economic development. The first measure was rural branch expansion. Nationalised banks were directed to identify centres for branch expansion by selecting the hitherto unbanked areas. The Lead Bank scheme was introduced assigning the responsibility of developing banking activities in the district to each of the nationalized banks. District Credit Plans were prepared and implemented by the nationalized banks with the co-operation of non-nationalised banks and support given by the state government authorities.

However, the planners were not satisfied with the progress made by the commercial banks in extending rural credits and making credit available to the weaker sections of the society. The government of India came out with programmes like Small Farmer's Development Agency and Marginal Farmer's and Agricultural Labourer's Development Agency as it was felt that a separate credit agency was necessary to cater to the needs of these target groups. The Narasimham Committee recommended establishment of RRBs in selected regions to extend credit facilities to the target groups. On the basis of Regional Rural Banks Act, 1975, the RRBs started appearing on the scene in those areas where co-operative system was weak and commercial banks were not very active.

The following table shows the performance of banks after nationalization:

Table 1.8
Performance of Commercial Banks after Nationalisation
(Rs. in crore)

Year	Branches(No.)	Deposits	Advances	Income	Net Profit
1975	20206	15618	10580	1567	39.7
1980	31176	43651	26925	4221	68.5
1989-90	45401	202662	125255	23169	505
2002-03	52380	1355654	739554	172345	17077.22
2003-04	53061	1575143	864143	183767	22272
2004-05	53726	1821885	1105725	186703	20706

Table No. 1.8 shows the performance of commercial banks during 1975 to 2004-05. The table shows that the number of branches had been increased from 20206 in 1975 to 53726 in 2005. Deposits have been increased from 15618 in 1975 to 1821885 in 2005. Advances have been increased from 10580 in 1975 to 1105725 in 2005 . Income have been increased from 1567 in 1975 to 186703 in 2005. Net profit have been increased from 39.7 in 1975 to 20706 in 2005. This shows that there is a tremendous improvement in the performance of Commercial Banks after nationalization.

Advances to Priority Sector:

After nationalization , the banks are given importance to priority sector, which includes, agriculture, small scale industries, small business people, transport operators, education and exports. This is explained in detail in the next chapter.

Lead Bank Scheme:

The lead bank scheme was introduced by the RBI towards the end of 1969 on the recommendations of the Nariman Committee with the objective of enabling the commercial banks to assume the role of leadership for the development of banking and credit facilities throughout the

country on the basis of area approach. Under this scheme, all the districts in the country have been allotted to the State bank Group, nationalized banks and private Indian banks. A lead bank is assigned the role of a catalytic agent of economic development through the expansion of bank branches and diversification of credit facilities in the district allotted to it. Andhra Bank is a lead bank for East and West Godavari Districts.

Towards Diversification and Innovation:

Along with policy-induced growth, banks have pursued market-induced growth through diversification and product innovation business.

Diversification Programmes of Banks

Product Diversification	**Business Diversification**
Automated Teller Machines	Merchant Banking
Consumer Credit Cards	Leasing
Form Credit Cards	Factoring
Traveller's Cheques	Mutual Funds
Investors Clubs	Port Folio Management
Home Loan Accounts	Venture Capital
Industrial Finance branches	Consumer Finance
Agricultural Finance Branches	Housing Finance
Overseas Branches	Share Deals

Product Diversification:

1. ***Automated Teller Machines:*** ATMs offer major benefit to consumers and banks alike. They provide the unprecedented privilege of 24 hour availability of some of the banking transactions and allow the banks to reduce branch overheads.
2. ***Consumer Credit Cards:*** Under this scheme, the depositor is required to deposit some amount in his account for which he is issued a Credit Card. He can use his card any where in the country for payment upto a certain percentage of his deposit. Thus this system relieves the business community from worry of carrying cash with them.
3. ***Farm Credit Cards:*** These cards are issued to farmers and used by them for any cash payment.
4. ***Travellers Cheques:*** Banks issued travelers cheques to the customers. The customer can carry far and wide and can get it encashed in any of the branches of that particular bank, in any part of the country. This ensures security to the traveler and his cash.
5. ***Investors Clubs:*** Investors Clubs are formed with the customers of the Banks.
6. ***Home Loan Account:*** Nationalised Banks introduced Home Loan Account. If a person open home loan account and deposit his money in it in monthly instalments for five years, loan will be given to him for the construction of the house.
7. ***Stock Invest Schemes:*** This schemes is helpful to shareholders for sending money for primary issues of the shares, the share holder will deposit money in the bank and get stock invest, which he can avail, shares are allotted to him.
8. ***Industry Finance Branch:*** For Financing industries, banks are separately opening branches.
9. ***Overseas Branches:*** Many banks are having branches in foreign countries. At the end of 30th June 1990 Commercial Branches have 115 foreign branches.

Business Diversification:

Diversification of the industry from Commercial Banking Service into investment banking services would comprise inter at a merchant banking, corporate stock broking, venture capital activities, investment advisory and management services for institutions and high net work and individuals covering equities, bonds and money market instruments, arrangement for Finance of mergers and acquisitions, business in Giltedged Securities, International Funds rising services, Mutual Funds etc.

1. Merchant Banking: Under this many banks launch Financial Services. They have started subsidiaries to under merchant banking activities like acting lead managers for Public issues, underwriting public issues, etc. Banks like SBI, Bank of Baroda, Canara Bank, Punjab National Bank etc., already launched subsidiaries and many other banks are in process of doing so.
2. Mutual Funds: Mutual Funds refers to mobilization or pooling of small and medium investors funds for investing in capital market instruments like Government and other Trustee Securities, shares and Debentures of Public Limited Companies, Bonds of Public Sector Undertakings etc.
3. Venture Capital: Venture Capital Financing is Finance extended to an emerging high task, hi-tech project based purely on research and development efforts.
4. Consumer Finance: Customers will be given finance to buy consumer durables.
5. Housing Finance: The establishment of National Housing Bank has given boost to entry of commercial banks in the areas of Housing Finance.
6. Portfolio Management: Banks which have expertise in investments are permitted to act as portfolio managers. Banks are managing the portfolio of large public sector corporation and they have designed specialized investment need of non-resident Indians.
Management of public issues, loan syndication financial and management consultancy services, Project Councelling, mergers and acquisitions, and management of non-resident investment are part of Merchant banking.
7. Leasing: Leasing is a method of Financing Capital equipment fixed assets. The banks have started Financing leasing companies from 1988 in the light of recommendations of committee of directions constituted by Reserve Bank of India.
8. Factoring: RBI constituted a study group under the Chairmanship of Mr. C. Kalyana Sundaram examine the feasibility of starting factoring organization in India keeping inview the delay in collection of receivables particulars in care of the smaller units.
The functions of Factoring Organisations are:
a) Credit and collection for its client.
b) Purchase receivables as they arise.
c) Monitors sales registers and attends to other book-keeping duties relating to such accounts.
d) Perform other auxiliary functions.

1.13 Summary:

The origin of Commercial Banking started in the early stages of human history. In England, banking had started with the Gold-smiths who began to accept deposits from merchants and others for safe-keeping of money and valuables in the 17the century. The first modern bank was set up in India in 1688 at Madras. Later Three Presidency banks, Bank of Bengal, Bank of Bombay and Bank of Madras were started. In 1921 these three banks were merged together and formed State Bank of India. The Scheme of social control was introduced in 1967 with the objective of strengthening the banking system by preventing bank failures and thus to sustain public confidence in banking and to promote the growth of banking on sound lines. In July 1969, 14 banks which has

capital of more than Rs.50 crores was nationalized to serve better the needs of development of the economy, in conformity with National Priorities an Objectives . In the year 1980 six more banks were nationalized. After nationalization banks have taken up many programmes like Lead Bank Scheme, Advances to priority sector and many diversification and innovative programmes.

1. 14. Key Words

1. Nationalization - The process of bringing the assets of a company into the ownership of the state
2. NCC - National Credit Council
3. NABARD - National Bank for Agriculture and Rural Development
4. R.R.B.s - Regional Rural Banks
5. SIDBI - Small Industries Development Bank of India
6. SEEUY - Self-employment Programme for Educational Un-employment Youth

1.15 Self Assessment Questions

Short Questions :

1.Evolution of Banking in ancient times
2. Devlopment of banking in England
3.History of banking in pre-nationalisation period
4. Give the reasons for nationalization of banks in India.
5. What are the objectives of social control.
6. What are the objectives of nationalization of commercial banks.
7. Give an account of diversification programmes of banks.

Essay Questions :

1. Describe the .structure of Indian Banking System.
2.Explain the evolution of banking in India in pre-nationalisation period.
3. Assess the development of banking in post-nationalisation period.

1.16 Suggested Readings

1. Mithani D.M. and Gorden E: Banking and Financial Systems, Himalaya Publication House
2. Srivastava P.K.: Banking Theory and Practice, Himalaya Publication House
   Ranganadhachary A.V. and Paul R.R.: Banking and Financial Systems, Kalyani Publications

Dr. Uttama Durga Devi

Lesson 2

COMMERCIAL BANKS

2.0 Objectives :

The objective of this chapter is to study the meaning of commercial bank and functions of these banks i.e. Primary functions and Secondary functions. Again secondary functions are divided into Agency Services and General Utility Services. Various systems of Banking and different types of banks are also explained.

Contents

2.1 Introduction
2.2 Definition of Bank and Banker
2.3 Definition as per Banking Regulation Act
2.4 Functions and Services of Commercial Banks
2.4.1Primary functions
2.4.2 Secondary functions
2.4.2.1Agency Services
2.4.2.2 General Utility Services
2.5 Systems of Banking
2.5.1 Branch Banking
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2.5.4 Chain Banking
2.5.5 Correspondent Banking
2.5.6 Deposit Banking
2.5.7 Mixed Banking
2.5.8 Industrial or Investment Banking
2.5.9 Scheduled and Non-Scheduled Commercial Banks
2.5.10 Universal Banking
2.5.11 Retail Banking
2.5.12 Virtual Banking
2.6 Types of Banks
2.7 Summary
2.8 Key Words
2.9 Self Assessment Questions
2.10 Suggested Readings

2.1 INTRODUCTION

Commercial Banks play an important role in directing affairs of the economy in various ways. As a matter of fact the operations of Commercial banks record the economic pulse of the

country. The size and composition of their transactions mirror the economic happenings in a country. Long back the well known 19th century economist David Ricardo had stated that a bank was a dealer or transactor in money in a financial system (sayers) It is the banks who set the tempo of aggregate economic activity in any economy.

Banking is different from money-lending but two terms have in practice been taken to convey the same meaning. Banking has two important functions to perform, one of accepting deposits and other of lending monies and \or investment of funds. It follows from the above that the rates of interest allowed on deposits and charged on advances must be known and reasonable. The money-lender advances money out of his own private wealth, hardly accepts deposits and usually charges high rates of interest. More often, the rates of interest relate to the needs of the borrower. Money-lending was practiced in all countries including India, much earlier than the present type of Banking came on scene.

2.2 DEFINITION OF BANK AND BANKER:

A modern commercial Bank performs many functions. It renders many services to its customers and also to the public. It is really very difficult to capture completely the profits of a bank or banker in a very few words.

However, let us try to have a look at various definitions of a bank and banker.

DR.HERBERT L HERT in his " A Banker is one who in the ordinary course of his business, honors cheques drawn upon him by persons from an for whom he receives money on current accounts"

SIR JOHN PAGET says that no person or body corporate of other wise, can be a banker, who does not [1] take deposit accounts [2] take current accounts [3] issue and pay cheques and [4] collect cheques crossed or uncrossed for his customers. According to this definition, a person or an association [whether incorporated or not] performing the above four functions can be called a banker.

The above definition is fairly exhaustive. This definition as well as the earlier one does not state the various agency or other subsidiary services performed by a modern bank.

SIR JOHN PAGER further says that the person claiming to be a banker must profess himself to be a banker and the public must accept him as such.

KINLAY writes " a bank is an establishment which makes to individuals such advances of money as may be required and safely made and to which individuals entrust money when not needed by them for use"

WALTER LEAF says " A bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque"

HORACE WHITE opines "A bank is a manufacturer of credit and a machine for a facilitating exchanges".

2.3 Definition as per Banking Regulation Act:

A Bank borrows by accepting deposits of money from the public. These deposits are to be repaid on demand or after fixed period. The depositors can withdraw them by cheque, draft, order or any other way. A Bank accepts deposits [i.e. borrows] for the purpose of lending mainly to traders, industrialists and manufacturers and the like as also for the purpose of investing in government securities to fulfil statutory obligations. Thus, Banking Regulation Act, 1949 defines " Banking as accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and with drawable by cheque, draft, order or otherwise." By and large, this definition can be taken to be satisfactory.

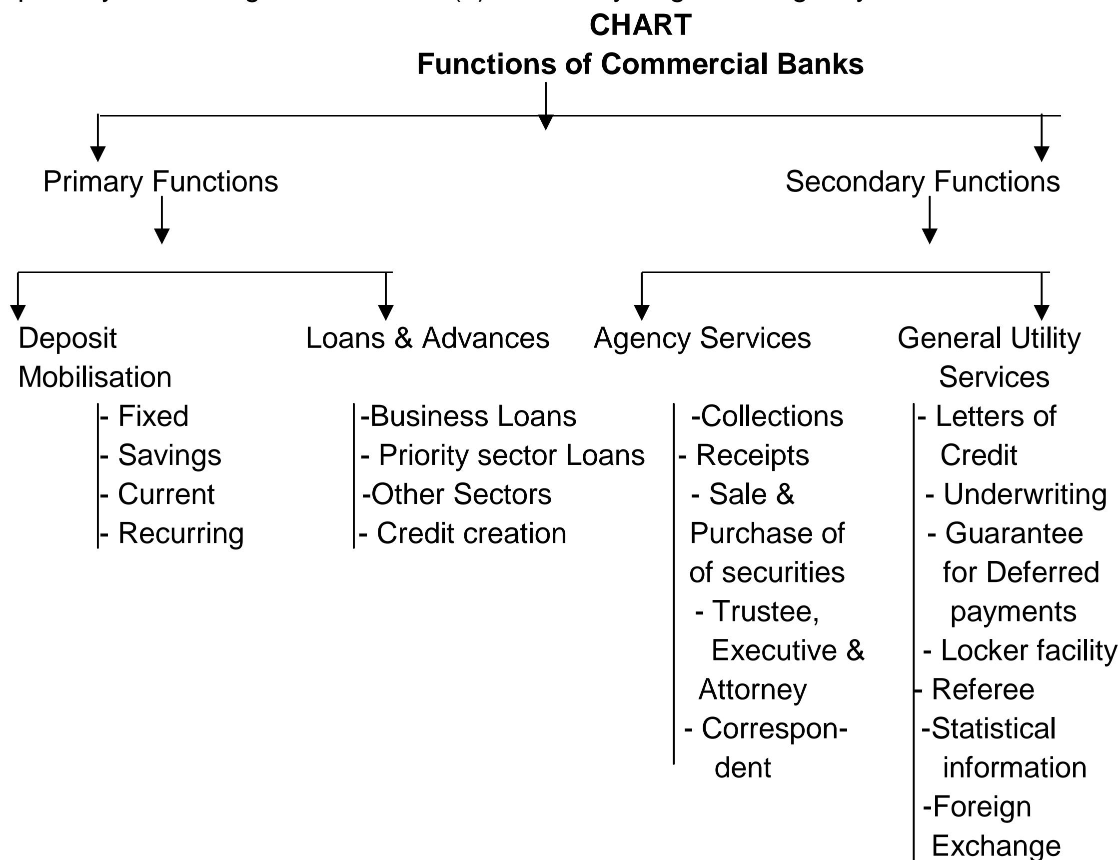
As par the provision of the Banking regulation Act [which we will discuss elaborately elsewhere] every company willing to do banking business must obtain license from the Reserve Bank for carrying on banking business in India. Besides, all companies carrying on banking business must use the word bank, banker or banking as part of their names. It may noted that money-lenders are not bankers.

2.4 FUNCTIONS AND SERVICES OF COMMERCIAL BANKS

Banks play a very important role in the economic life of a country. They control the total supply of money in circulation and there by influence the nature and character of production in the country. We can understand the economic significance of banks by reviewing their functions. The functions of commercial banks can be broadly classified under two heads; (a) primary or banking functions and (b) subsidiary or general agency functions.

CHART

Functions of Commercial Banks



2.4.1 .PRIMARY FUNCTIONS

1. Accepting Deposits : This is the most important function of commercial banks. They accept deposits of three types, namely, (a) Current Account Deposits (b) Savings Deposits and (c) Fixed Deposits.

Saving Bank Deposits: Savings deposits are the deposits on which the bank pays some interest and put some restrictions on the withdrawls.

Current account deposits: Current account deposits or demand deposits are repayable on demand. There are no restrictions on the withdrawals from this account. Banks usefully do not pay interest on the demand deposits.

Fixed Deposits: Fixed deposits are the deposits ar kept in a bank for a fixed period. They cannot be withdrawn before the expiry of the period. The rate of interest on fixed deposits varies with the length of the period and the amount of deposits.

Thus, by accepting deposits, banks mobilise the savings of the people and use them for productive purposes. The acceptance of deposits is useful to the depositors in many ways. Banks protect the depsitors money from theft or loss and provide an easy and convenient means of transferring money through cheques. They also pay interest on fixed and savings deposits.

2. Giving Loans and Advances: This is the function by performing which the banks earn an income. The bank mobilizes the dominant capital of the people and provides the same for productive purposes. The money collected in the form of the deposits will be lent to producers and businessmen. They grant loans and advances to businessmen only for short periods. They lend only to approved customers against personal security. Gold, silver, stock of goods etc. They grant loans and advances in the form of a) overdrafts b) cash credits c) Loans d) discounting of bills.

An overdraft is a temporary loan granted by the bank to its customer. It is an arrangement under which the customer is allowed to overdraw (i.e. draw more than the balance to his credit) on his account upto a specified period interest is charged on the amount actually overdrawn by the customer.

Cash credit is an arrangement under which the borrower is allowed to borrow money upto a certain limit against a bond of credit. The borrower has to provide one or more sureties or some securities like stocks, shares etc. Interest is charged on the amount actually overdrawn by the customer.

The banker also grants loans to his customers against some security. The whole amount is credited to the customers current account interest is charged on the whole amount of credit irrespective of the amount actually withdrawn by the customer. The bank also undertakes to discount the bills or exchanger or hundis of the customers.

It purchases the bill or hundi of the customer and pays him the amount of the bill after deducting the interest i.e. discount. The bank will collect the bill on the due date .In case of dishonour the bank recovers the amount from the concerned customer.

Loans to Priority sector:

Priority sector includes agriculture, small scale industry, small business, transport operators, education and exports etc. After nationalization Banks are asked to give 40% of their loans to priority sector. This will help for development of weaker sections of the society.

Loans to Other sectors:

Bank give loans to other sectors like industrial, co-operative housing, consumption, social and religious celebrations, purposes etc., taking into account the merits of the cases.

Credit Creation:

Creation of credit is an outstanding function of commercial banks. They are therefore called not merely purveyors of money but also manufacturers of money. This function has a greater economic significance because it is this function which can stimulate or contract economic activity in the country.

Credit creation can be defined as the expansion of bank deposits through the process of more loans and advances and investments. In other words, Bank credit means bank loans and advances. A bank keeps a certain proportion of its deposits as minimum reserve for meeting the demand of the depositors and lends out the remaining excess reserve to earn income. The bank loan is not paid directly to the borrower but is only credited in his account. Every bank loan creates an equivalent deposit in the bank. Thus, credit creation means multiple expansion of bank deposits.

2.4.2 Secondary Functions:

Apart from the above primary and economic functions modern bank performs a host of other functions of a non-banking character primarily for the convenience of its clients. Such non-banking functions are called secondary functions or subsidiary functions. These again can be divided into two categories.(s) agency services and b) general utility services.

The kind of services which we can consider as “subsidary services” to the main business of banking [listed above] can be listed as under:

Bank;

a) May act as a agent for any government of local authority or any other person or personal but it cannot act as a managing agent or secretary and treasurer of company

b)may contract for public and private loans and negotiate and issue them;

c)may effect, insurance, guarantees, underwrite, participate in managing and carrying out of any issue of loans or securities made by state, municipality, company, corporation, any other association and may also lend for the purpose.

d)may carry on and transact every kind of guarantee and indemnity business;

e) may manage, sell and realise any property which may come into its possession in satisfactional of its claims;

f) May acquire, hold and deal with any property or any right, tittle or entrust therein which forms the security for any loans or advances sanctioned;

g) May undertake and execute trust;

h) may undertake the administration of estates as executor, trustee or otherwise;

i) may establish and support or aid in the establishment of associations, institutions., funds trusts, and conveniences for the benefit of its present or past employees and their dependence and may grant or guarantee monies for charitable purposes;

j) may acquire, construct, maintain and alter any building or works necessary for its purpose;

k) may sell, improve, may manage, develop, exchange, lese, ,mortguage, dispose off or otherwise deal with any of its properties and rights;

l) may take over and undertake the whole or any part of the business of any person or company when such business is of a nature described above;

m) may do all such other things as ar incidental or conducive to the promotion or advancement of its business;

n) may engage in any other form of business which the Central Government specifies to be lawful;

The last two are general clause which indicate that the above list of activities is exhaustive but not comprehensive.

Of the several kinds of services listed above, both under main business as well as under anciliary services, we can furnish the services falling under the caption “agency services’ and “general utility services”

2.4.2.1 Agency services

1] The issuing on commission and underwriting stock, funds, shares etc., investments of all kinds; (under [a]);

2] The collecting of bills of exchange, hundies, promissory notes, cheques and securities (under[a]);

3] The issuing on commission and underwriting of stock, shares, funds etc, (under[a]);

4] The purchasing and selling of shares, G.P.Notes, bonds, debentures etc. on behalf of constituents (under[a]);

5] The negotiation of loans and advances (under[a])

6] The transmitting of money, i.e. by demand drafts, mail and telegraphic transfers (under[a]).

7] The granting and issuing of letters of credit, travellers cheques and circular notes (under[a]).

8] The buying and selling of foreign exchange including foreign bank notes (under[a).

9] Acting as agents for any Government, local authority etc.(under[I]).

10] Contracting for public and private loans (under[c])/

11] undertaking and executing trusts (under[h]).

12] undertaking the administration of estates as executor, trustee or otherwise (under[I]).

Banks have been permitted to setup money market mutual funds. Some banks have entered into venture capital financing. Housing Finance has also been taken as a focused

banking activity. Credit card business is yet another activity undertaken by certain banks. Again, the Government has permitted eight banks to undertake trading in gold and silver.

It will thus be seen that a bank renders many valuable services to the public as well as to the trade an industry of a country. Its most important service is that it pools together the scattered savings of a community and makes them available to those who need funds for productive purposes. They are also benefited by the advice and information which banks are always ready to place at their disposal . Further, it has been aptly said that the existence of a sound and competitive banking system is in itself an encouragement to saving, thrift and economy for even the small investor is made to appreciate the facilities of safe investment which a bank provides, an is thus imbued with a feeling of security.

2.4.2.2 GENERAL UTILITY SERVICES

These services are those I which the banks position is not that of an agent for his customer. They include the issue of credit instruments like letters of credit and travellers cheques the acceptance of bills of exchange; the safe custody of valuables an documents; the transaction of foreign exchange business; acting as a reference as to the respectability and financial standing of customers, providing specialized advisory service to customers; etc,

Bankers drafts and Letters of credit

A bankers draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to pay a specified sum to the person concerned.

A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document, to the extent of a stated amount in the letter and charge the same to the extent of a stated amount in the letter and charge the same to the account of the grantor of the letter of credit.'circular letters of credit' are generally intended for travellers who may require money in different countries. A 'travellers letter of credit' and 'guarantee letter of credit' the bank secures a guarantee for reimbursement at an agreed rate of interest, or it may insist on sufficient security for the grant of credit. 'Revolving Credit' here the letter is worded that the amount of credit available automatically reverts to the original amount after the bills negotiated under them is duly honoured.

Circular Notes, Travellers cheques, Circular Cheques.

'circular notes' are cheques on the issuing banker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the name of the holder and referring to a letter of indication in his hands, containing the specimen signature of the holder. 'Travellers cheques' are documents similar to circular notes with the exception that any letter of indication does not accompany them. "circular cheques" are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

Safe Custody of Valuables

Another important service rendered by a modern commercial bank is that of keeping in safe custody valuables such as negotiable securities, jewellery, documents of title, wills, deed-boxes, etc. These maybe used for a small fee. Each user is provided with the key of an

individual safe and thus, not only obtains protectional of his \ her valuables but also retains full personal control over them.

Night safes

For shopkeepers and other customers who handle large sums of money after banking hours, night safes are available at many banks strong room

Credit Cards

A credit cards is basically a payment mechanism which allows the holder of the card to make purchases without any immediate cash payment. Credit limit is fixed by the issuing bank and the limit is determined by the financial history as well as the type of card. The issuing bank makes the payment to the merchant establishment selling the relevant goods or services. The holder to whom the card is issued, in turn, reimburses the bank on receipt of the bill in statement.

Encouraged by the kisan credit card scheme. Laghu Udyami credit cards have been introduced in India for providing simplified and borrower –friendly credit facilities to retail traders, artisans, professionals and self-employed persons, small industrial units and small industrial units and small business men including those in the tiny sector

Debit card

In the case of a debit card , it runs down one's deposit account at the moment the sale is made. In other words, while making a payment to a merchant establishment by using a debit card, it assumes the form of a transaction between the establishment and one's bank account. Debit cards are more readily accepted by merchant establishments since they get instant payment. Debit cards free the cardholder has to be extremely careful with the card. If the card is lost or is stolen , the entire balance in the bank account could be emptied with a single purchase by an unscrupulous person.

Budget Accounts

Some banks are opening budget accounts for creditworthy customers. The bank guarantees to pay, for a specific charge, certain types of annual bills (e.g. fuel bills, rates, etc) promptly as they become due, while repayments are spread over a twelve- monthly period from the customers account.

Electronic funds transfer (EFT) service

Another important service, which is of comparatively recent origin, is the electronic funds transfer (EFT) service. This is a service under which funds are transferred electronically over the telephone, either transferred electronically over the telephone, either nationally or internationally, international funds transfers from applicant to beneficiary are made in as little as a few seconds. The international network known as "SWIFT'(society for work wide interbank financial telecommunications) , an organization promoted by banks and financial institutions around the world, is utilized to facilitate the speedy transfer of funds across international destinations without any paper work and expeditious efficiency. SWIFT is the largest network in the world, which has around 4800 users in 130 countries. This is a path breaking technology

that will ultimately pave the way in curing the corporate sector's headaches of cash management in multiple locations.

Overseas trading services

Recognition of overseas trade has encouraged modern commercial banks to set up branches specializing in the finance of foreign trade. Banks in some countries have taken interest in export houses and factoring organizations. Assisted by banks affiliated to them in overseas territories, they are able to provide a comprehensive network of services of foreign banking business.

Information and other services

Some banks produce regular bulletins on trade and economic conditions at home and abroad, and special reports on commodities and markets. In some cases, they invite enquiries from those wishing to extend their foreign trade, and are able through their correspondents to furnish the names of reputable and interested dealers of goods and commodities and to advise on the appointment of suitable agents.

Draft facilities

It is much costly and risky to send large amounts of money order (MO). but it is very safe and cheap to send the same through banks by means of demand drafts.

Underwriting

Banks underwrite share capital to be raised by government, public bodies, corporations and others. However, in India, participation of banks in such underwriting business is not much popular unlike that in Germany

.

Guarantee for deferred payments:

Importers of our country may not be able to pay immediately for the goods imported in certain cases. Then they may request for the facility of installment payment system. In such a case banks may give guarantee for installment payments of the importer.

Locker facility:

A modern bank receives valuables such as securities, jewelry , and documents of title to goods and so on from its customers for safe custody. For this purpose, it provides locker facility. Rule of a bank in this regard is a custodian. The customer is relived of tension and panic about the safety of his belongings.

Referee:

Bank serve as referees to the financial standing, business reputation and responsibility of their customers. This function is in the process of development in India. This business units, as such, have taken great care for collecting such information. Further utmost secrecy should be maintained about this.

Business and statistical information

Banks collect business information regarding possibilities of trade, commerce and industry. Some banks publish their monthly bulletins or periodicals with valuable statistics secured from national and international sources, on financial matters. This will be of immense use for the mercantile community.

Foreign exchange dealings

In the early days, one of the most important functions of goldsmiths, lenders and bankers was money changing, letters of credit issued by them to merchants were carried to other countries where they were accepted in the settlement of transactions. Later on, Liyoda and Lombardians were agencies for exchanging currencies. These functions developed further into a full-fledged activity of modern commercial banks through their branches, offices or correspondent banks. In other countries to trade in foreign currencies. Although central bank may intervene in times of difficulty, banks engage in currency exchange as a normal function without an intermediary. This function has increased security of commercial banks, as foreign exchange reserves in other overseas offices swelled and it has helped to increase their liquidity.

Some countries insist upon special license to deal in foreign exchange. Commercial banks with a license to transact foreign currencies are not small in number. Foreign banks in a country are authorized dealers in foreign exchange reserves popular foreign banks like Liyods Bank, Barclays Bank, National and Grindlays bank, Chase bank, American express international banking corporation, Mitsui bank of Tokyo, Bangui national despairs, Lombard bank, state bank of India and bank of Baroda have branches in almost all the countries. The position of foreign banks is better and more independent so far as their dealings with exporters and importers are concerned. Foreign trade, tourism and international and multinational investments are the fields in which exchange banks are engaged.

2.5 Systems of Banking:

Structure of banking varies from country to country. Traditions, economic and political conditions and public attitude will determine the banking structure. As banking institutions have been developed, several banking systems came into existence.

The most important systems of banking among them are branch banking and unit banking. In addition, there are three other types of banking namely Group Banking, Chain banking and Correspondent banking.

2.5.1 Branch banking:

Branch banking is a system of banking where its business operated by the head office through a network of branches s[read out in different parts of the country. Head office is generally situated I a big city and branches operate at different parts the country. In this system, every bank has legal entity with one board of directors and one group of share holders. Banking system board of directors and one group of shareholders. Banking system in England is an example for branch banking. Banking organization in England to a larger extent, is vested in the hands of five big banks (Big Fives) viz. Midland, Lloyds, Barclays, Westminster and national provincial. They have over 12000 branches and control over 75% banking resources of

that country. Similarly, in India 28 public sector banks were having 27,214 branches pf the total 55015 branches in the country by March 1988. It meant 2-3rds of Indian banking is vested in public sector.

2.5.2 Unit banking:

Unit banking is a type of banking in which each banking institution is independent of other banks and its operations are confined mostly to a single office-within a narrow area, under this system, banking operations are carried trough a single office tatter than by a network of branches. Of course a few unit bans may have branches operating within limited area. Strictly speaking, this is a localized banking. In this system, each banking company is a separate company licensed separately, it has its owe system, area of operations and size of bank is smaller and fare more limited than is the case under branch banking system. Unit banking is popular in U.S.A. till recently. By 1975, of the 14,457 total banks is USA, 8334 (over 65) were unit banks.

2.5.2.1 Branch banking Vs unit banking:

Branch banking and unit banking are like South Pole and North Pole. They never come together. One is contrast to the other. Further a comparison between small scale and large-scale operations. Definitely a bank with branches has certain advantages over unit bank. Such advantages of branch banking are incidentally the drawbacks of unit banking and vice versa, now let s consider relative merits and demerits of each system.

Advantages of branch banking or draw backs of unit banking:

(!)**Mobilization of savings:** In the case of branch banking, banks can mobilise the savings from potential and surplus areas to the areas where they are highly needed. So there is a possibly to earn sound profits also. It is not possible for the unit banking to mobilise funds from one area to another or to earn profits thereby.

(2) **Efficiency in management:** Branch banking provides greater scope for efficient management. Best personnel may be recruited for top management. Branch managers are carefully selected, trained and supervised. Exports in different fields may be appointed at the head office and their services are made available to the branches. Limited resources of unit bank do not permit the appointment of experts, who claim heavy remuneration.

(3)**Large scale Operations:** Branch banking enjoys certain economics of large scale operations and reaps all advantages of divisional of labour. It can utilise experts services for tackling several problems of modern management and devote in technological innovations in the working of branches to get maximum benefit. But unit banking is handicapped with its meager resources to enjoy the economies of large scale operations.

(4)**Diversification of Deposits and Advances:** Branch banking provides a wider scope for selection of diverse deposits and varied advances. Deposits are received from different

deposits and varied areas/. Hence the position of deposits cannot be disturbed easily. In the same way, loans are given at different places for different purposes to different places for different purposes to different borrowers. But to this diversification, risks of banks are scattered over a number of industries and over a wider area. This is not k possible for a unit bank situated and operating in a particular area.

(5)**Economy In maintaining reserves:** In order to maximize their profits, the banks have to keep a reserve as low as possible but at the same time, they have to maintain adequate cash reserves to meet the demands of depositors. Reserves: Since funds can be moved very easily from on branch to another, each branch maintains low cash reserves in branch banking. But unit banks do not possess this facility and they have to depend exclusively on their resources. Though they can draw from their correspondent banks, the scope, is very much limited.

6) **Efficient Management:** Branch banking is more efficient than unit banking because the branch with a network of branches can appoint best personnel for top management. Branch managers are carefully selected , trained and supervised. Experts from different fields may be appointed at the head-office and their services are made available to the branches. Limited resources of unit bank does not permit the appoint of experts who claim their remuneration.

7) **Diversification of funds:** In the case of branch banking a bank with a number of branches scattered over a wide area. They collect the deposits from all areas and utilizes the same for the branch where there is an urgent need In fact branch bank constantly transfer funds from areas where there are abundant to where they are shortage. . In the same way loans are given at different places for different purposes to different borrowers. Due to this diversification, risks of banks are scattered over a number of industries and over a wider area. This is not possible for a unit bank

8)**Effective control by a Central Bank:** In the case of branch banking the number of banks is less. It makes the central bank easy to control them. But this is not possible in the case of unit banks because the number of unit banks is very large. And it is difficult to get proper response from them.

9)**Uniform Interest rates:** Branch banking facilities and mobility of capital brings about uniformity in the rates of interest all over the country. Branch banks continuously surplus areas to scarce are to balance the rates of interest prevailing in different jinn different parts of country. This is not possible in the case of unit banking.

10)**Large Financial resources:** In the case of branch banking, there is number of branches operating in different parts of the country, it is possible to secure large amount of deposits . Hence Branch banks can lend the amounts for big projects at favorable conditions. But in the case of unit banking, this is not possible. As the branches are less they will have only limited funds. So they can not lend the money in large amounts.

11) **Economy in working:** Branch banking system achieved greater in working. Funds are made available in plenty and at lower rates of interest. Hence internal and foreign exchange business can be handled economically. Under unit banking, it is not possible.

12)**Provide banking facilities in rural areas:** Only branch banking can start branches in rural, backward and unbanked areas and provide banking facilities to the people. This is not possible in the case of unit banking system.

13)**High banking standards:** AS branches are operating at different parts of the country, it is possible for the branch banking, to have a complete understanding about economic and conditions and problems of the people. Head office collects all the information from its branches, to frame its policies. But this is not possible for unit banking.

14) **Establishment cost:** In the case of branch banking as the branch operations are in large scale, the establishment is very less. As the purchase the equipment and machinery in bulk quantity, they will get at the lesser price.

15)**Loans to deserving borrowers:** Under branch banking, loans are sanctioned on merit of each case. Branch manager need not yield to local pressures. He can refuse the loan to undeserved party and throw the responsibility of refusal to the head office. This is not possible in the cases of unit banking.

16)**Impact of failure of borrowers in an area:** Some times the borrowers may fail to repay the loan amount. In this case, this needs to lead to close the branch. Because in the case of branch banking system, the bank is financially sound, and if one bank fails, the funds can be transferred from other bank. But in the case of unit banking system, the failure of borrower of a big amount leads to the failure of the bank.

Disadvantages of Branch Banking:

Though the above advantages support the branch banking, there are some disadvantages of unit banking. The following are the disadvantages of branch banking.

1. **Local funds for local development:** The unit bank of a particular locality utilizes its resources for the development of its own locality only and does not transfer them to other localities like branch banks.

2. **Intimate knowledge of customers:** In the case of unit banking, since the manager is a local person, he can easily acquire the personal knowledge of his customers and specialized knowledge of local industries and occupations. He is in a better position to serve the needs of the local borrowers . There is also chance of cultivating personal relationship with the individual entrepreneurs This will help him to observe the performance of customers and industries and thereby recover the loans easily.

3. **Difficulty in management**: In the case of branch banking, management becomes difficult with the increase in the number of branches. Head office may find it difficult, to control and super wise the branches at distant places efficiently. Undue expansion is accompanied by dangers of mis-management, in competency. In case of unit banking, as there is only one branch management is easy and effective.

4.Very expensive: Branch banking is very expensive. As too many branches are to be opened, establishment expenses and maintenance charges to bound to increase. The cost is very high and it is difficult for the head office to manage. In the case of unit bank, all such expenses can be reduced to minimum, since the size is in the limit of control.

5.Delaying decisions: In the case of branch banking system, there are many procedures and formality. Because for everything, sanction must come from Head Office. During the process of any service, if a particular manager is transferred then the whole operation coomrs to a still worse because of which the customers are badly affected.

6.Limited Authority: The employees of the branch are put to monotonous and routine work,. Because the branch manager has limited authority. The head office controls the activities of the branch . The branch manager cannot provide innovative services to the branch.

7.Cutthroat competition: Under branch banking, a number of branches are opened indiscriminately . This results in cutthroat competition, rate cutting, offering high rates of interest to attract deposits, risky investments etc. In case of unit banking, banks take care in prevention of such evils.

8.Monopoly Power: Branch bank creates some sort of monopoly power in few hands which is departmental to the economy of a country. With the existence of few banks, the banking activities in the country are controlled by those banks. The Big Five Banks in England and Public Sector Banks in India 75% and 93% respectively of the banking business.

Inspite of the above disadvantages, the branch banking system has few more substantial merits and hence is still surviving in major countries. I

Advantages of Unit Banking:

Unit banking enjoys several advantages over branch banking. These advantages are as follows:

1. **Local funds for local development:** The unit bank of a particular locality utilizes its resources for the development of its own locality only and does not transfer them to other localities like branch banks.
2. **Intimate knowledge of customers:** The manager of a local unit bank can easily acquire the personal knowledge of his customers as well as the specialized knowledge of the local industries and occupations. Therefore, he is in a better position to serve the needs of the local borrowers. He has greater chances of cultivating friendly and personal relationship with the individual entrepreneurs of his locality.
3. **Management easy:** Management and supervision of a unit bank do not offer any serious problems. Fraud and irregularities generally cannot take place in a unit bank. Thus, a unit bank enjoys all the advantages of small scale operations.
4. **Benefits to local people:** The banking business of a unit bank is integrated with the local economic and social organization, from which not only its shareholders, directors and officers but also its principal customers both depositors and borrowers are drawn. It is thus particularly associated with the local activities.

2.5.3 Group Banking:

Group Banking is an arrangement under which two or more separately incorporated banks are brought under the control of a single management in the form of a holding company. The banks so brought together under a single management may be unit banks or branch banks or both.

2.5.3.1 Advantages of Group Banking:

1. Though the bank comes under the control of a holding company, it enjoys its own identity and maintains its own board of directors.
2. The central management (i.e. holding company management) ensures the liquidity of financial resources of the member banks.
3. It exercises economy in advertisement expenditure.
4. Since the Central management is very sound, it can easily use the services of experts in the management of the business of the member banks.

2.5.3.2 Demerits of Group Banking:

Failure of any member banks results in adverse effects on the other member-banks.

2. High level of efficiency may not be achieved under this system because the central management may not be able to enforce the code of discipline on the member banks.

3. It may give rise to corruption in the bulk purchases of stores, large-scale advertisement etc.

2.5.4 Chain Banking:

Chain Banking is basically a development over the group banking system. It is an arrangement under which two or more separately incorporated banks are brought under a common control other than by a device other than a holding company. The power is vested on a single person, by the members of the same family, by the same group of persons, through the ownership of stock, through common membership of board of directors otherwise. For example the managing directors of 3 or 4 banks can have a memorandum of understanding. This internal group shall control the member banks. So. The banks coming under the group are called as chain banks.

2.5.4.1 Advantages of Chain Banking:

1.Optimum Utilization of financial resources: As efficient managing directors are there, , there is a possibility of optimum utilization of funds.

2. It provides better managerial services.

3.Diversify the risks in banking business: As many branches are there, if one branch is in risk, then it can get the funds from other branches.

4.Minimizes the operational costs: Since many banks are there, it will have large-scale operations which helps in reducing the operational costs.

Benefits of large-scale operations: Since there is centralized administrative control, there is possibility of advantages of large-scale operations.

2.5.4.2 Demerits of Chain Banking:

1. The member banks may undertake speculative activities.
2. It lacks flexibility in the working of the banks.
3. It leads to corruption on the part of the bank employees and officers.
4. It suffers from lack of efficient management and supervision.

2.5.5 Correspondent Banking:

Correspondent Banking is in those centuries, where unit banking system is in operation. Under this system the banks maintain a correspondent relationship with one another through deposits. The banks in the rural areas will have deposits in the nearby towns. The town banks will have their deposits and cash reserves in city banks in turn in smaller banks. The smaller banks are called respondent banks and the bigger banks are called correspondent banks. The correspondent bank performs services like outside cheque clearing and participation in loans and transfer of funds etc. to their funds etc. to their respondent banks.

2.5.6 Deposit banking:

The important function of banks to accept deposits from the public which are repayable on demand and to lend loans and advances to trade and industry for meeting their working capital requirements. The system of attracting deposits for the purpose of short term lending is known as deposit banking. The main principle of deposit banking is that commercial banks are the custodians of the savings of depositors. They should not endanger the savings of depositors, by investing them in the long term loans.

2.5.7 Mixed Banking:

Mixed banking consists of accepting deposits from the public, and giving both short term and long term loans. Under mixed banking system, banks play a major role, in the industrial development of the nation. India, being a developing economy, there is a need of undertaking a risk of heavy capital expenditure. Hence, there is a need of financial resources in India, banks have come forward to adopt mixed banking since 1950's. The system was recommended by Central Banking Enquiry Committee (1931), The Shroff Committee (1954). From then banks have been banks have been directly participating in industrial development by lending long term and short term loans and indirectly participating by purchasing shares and debentures of IFCI and various SFCs

2.5.8 Industrial or investment banking:

The industries require loans for expansion and re-organisation of their business such as extension of the factory building, purchase of new capital requirements etc. If the long term capital is provided by the banks, it is known as investment banking or industrial banking. If banks are established to provide such long term finance to industries, such banks are called industrial banks or investment banks.

2.5.9 Scheduled and Non-Scheduled Commercial Banks:

The commercial banks are classified into Scheduled and Non-Scheduled banks. As per Section 2(e) of the RBI Act, a Scheduled bank means a bank included in the Second

Scheduled. A bank which fulfils the following conditions is deemed to be a Scheduled Bank (Section 42 (6) of the RBI Act):

1) It should carry on its business of banking in India.
2) It must have a paid-up capital and reserves fixed by RBI from time to time.
3) It must be a State Co-operative bank or a company as defined in the Companies Act, 1956 or an institution notified by the Central Government for this purpose.
4) It must satisfy the Reserve Bank of India that its affairs are not conducted in a manner that is detrimental to the interest of the public

A Bank whose name does not appear in the Second Schedule is termed as Non-scheduled Bank. One of the reasons for not including these banks in the Schedule is due to lesser paid-up capital reserves as prescribed by the RBI Act. These banks also carry on the business of banking as per the regulations prescribed by the RBI.

2.5.10 Universal Banking

Meaning:

Universal Bank is a financial super market offering multifarious products under one roof. It is one stop-shopping for a customer, who is willing to deal in several financial products. Universal Bank apart from doing the traditional banking of accepting deposits and providing loans, will also offer, Insurance products, Mutual Funds, Advisory Services and many a number of Investment Banking products. Universal Banking is not new to countries like Switzerland, France, Italy, Germany and USA. During, 1930, US banned Universal Banking activities with an Idea to mitigate risky behaviours of commercial banks in forgetting the main business of deposits and lending.

The globalization and opening up of the economy in India, several foreign players in insurance and investment banking activities have entered the Indian financial and banking sectors. This has given scope for all commercial banks in India marching towards Universal Banking., particularly the new private sector Banks. The commercial banks selling Insurance products is popularly known as bank assurance has became highly beneficial in earning revenues to the banks without much risk. Banks began earning a huge fees based income by way of commission as corporate distributor. The number of private sector banks and foreign banks opening branches in India has made it inevitable for them to expand their activities other than traditional Banking.

The recommendations of Narasimham Committee and Khan Committee for consolidation of banking through mergers and amalgamations, has brought about a change in commercial banks and marching them towards Universal Banking.

“ Universal banking is thus, nothing but embracing a whole new objective through transformation. It is the new way of thinking, changing attitudes and functioning to the expectations of tomorrows world of Banking. Universal Banking foresees the opportunities that lie beyond”

Activities of Universal Banks:

Universal banking adapts, adopts and achieves the basic objectives of business through technology. In this process, the ultimate beneficiary is the customer, who reaps the benefits of “world class banking products and financial services”.

As all the banking organizations are marching towards Universal Banking, the distinction in the operations of co-operative bans, development banks and non-Banking financial companies is gradually blurring.

The main objective of "Universalisation of banking is to earn as much as profit by way of interest, fees based income and commission through various diversified activities. Among the new private sector banks, ICICI Bank, Kotak Mahindra Bank Ltd., HDFC Bank Ltd., and Development Credit Bank Ltd., have become very aggressive in marching towards Universal Banking. These banks have made strategic alliances with several Foreign Insurance companies for selling the insurance products both in Life and general branches. ICICI Bank has itself started selling insurance with direct strategic alliance with Lombard and Prudential Life of United Kingdom for Non-life and Life Insurance respectively. DCB Ltd. on the other hand made strategic alliances for Insurance selling with Indian Insurance companies who have tie up with foreign insurance companies.

Benefits of Universal Banking:

a) One stop-shopping saves a lot of transaction costs and increases the speed of economic activity.
b) Emerging as global players in the market.
c) Earning revenue with less risk.
d) Continuity of income from the business sourced in Insurance.
e) Less regulatory restrictions from Government.
f) Reduces corporate Financing costs.
g) Exploitation of technology in full.
h) Acquiring expertise in diversified activities in financial services.
i) Expansion of client base.
j) Gearing up marketing and selling activities with lesser costs under one stop-stop.
k) Reaching the remotest clients.
l) Using the instrument in one activity to exploit the other.

2.5.11 Retail Banking:

As per industry estimates, the overall Retail Credit disbursements have grown by 30% during the Financial Year 2005, as against a growth of 12.6% in the last fiscal. The segments-wise break up of these disbursements, over a period of last three years is as under:

(Rupees in crores)

Loan Category	Financial Year 2005	Financial Year 2004	Financial Year 2003
Home	60,000	47,000	42,000
Auto	29,000	20,000	19,200
Commercial	24,000	19,000	13,800
Personal/Commercial	10,500	10,500	10,200
Two-Wheeler	6,500	3,500	3,600
Total	**1,30,000**	**1,00,000**	**88,800**

Source: IBA Bulletin August, 2005.

Home loans account for a whopping 46% of retail loans. There may be varies reasons e.g. Rising Property
Prices, Higher Income Levels, Low Interest Rates Regime, continuous availability of Tax benefits, etc.

As per Society of Indian Automobile Manufacturers, domestic passenger car sales grew by 17.8% to nearly 8.2 lakh units in financial year 2005 against 7 lakh units last year. The used car sales market is also estimated at 70 to 90% of new car sales and the car buying appetite is also going up, in view of easy financing options available from the organized and unorganized financial sector and also in view of higher disposable income and increased family comfort criteria.

In the last two years, auto and two wheeler loans showed higher growth than home and personal loans. Both in fact accounted for 70% of overall retail loan growth. Thus the demand in Retail Segment Loans has been tremendous and keeping in view the future potential, various banks have been launching a number of retail lending schemes for which plethora of necessary guidelines are being issued.

However, as a first step the concerned Bank must reformulate the entire gambit of retail credit schemes under a single umbrella of “Retail Schemes”.

2.5.12Virtual Banking:

Virtual Banking denotes providing related services through extensive use of information technology without direct recourse to the bank by the customer. After implementation Narasimham Committee recommendations information technology has been introuduced in the banking sector extensively. The important virtual banking services are Automated Teller Machines (ATMs) ,SWADHAN - Shared Payment Network System (SPNS) of ATMs, Electronic Funds Transfer at Point of Sale (EFTPOS), Smart Cards, Stored- Value Cards, Phone Banking, and more recently, internet and internet banking.

The financial benefits of virtual banking are manifold.

Firstly, virtual banking has the advantage of having a lower cost of handling a transaction via the virtual resource compared to the cost of handling the transaction via the branch.

Secondly, the increased speed of response to customer requirements under virtual banking vis-à-vis branch banking can enhance customer satisfaction and, circumstances remaining the same, can lead to higher profits via handling a large number of customer accounts.

Thirdly, the lower cost of operating branch network along with reduced staff costs leads to cost efficiency under virtual banking.

Fourthly, virtual banking allows the possibility of improved quality and an enlarged range of services being available to the customer more rapidly and accurately at his convenience.

2.6 Types of Banks:

1. Commercial Banks: The banks which perform all kinds of banking business and generally finance trade and commerce are called commercial banks. State Bank of India, Andhra Bank, Corporation Bank etc. are examples for commercial banks. Majority of the commercial banks in India are in the public sector. But, there are certain private sector banks operating as joint stock companies. Hence, the commercial banks are also called joint stock banks.

2. Development Banks: Bank which are meant to provide long term credit to industry and trade are called development banks. These are also called industrial banks, long term lending institutions, corporate financial units.

Development banks are of three types, a) Local Development Banks, b) National Development banks, and c) International Development Banks. Development banks which operate within the state or district are called local development banks. A.P. Industrial Development Corporation, A.P. Industrial Infrastructure Development Corporation are examples of Local Development Banks.

Development banks which extend their activities to the entire country are called National Development Banks. Industrial Finance Corporation , Industrial Investment and Credit Corporation of India (ICICI), are examples of National Development Banks. Development banks which cover several countries in the world are called International Development Banks, e.g. International Bank for Reconstruction , IMF, Asian Development Banks etc.

3. Savings Banks: The main purpose of saving banks is to promote saving habits among the general public and mobilise their small savings. In India, Post office savings banks can be described as the exclusive savings banks.

4. Exchange Banks: Exchange Banks are also commercial banks engaged in the foreign exchange transactions. They also received deposits and lend money. They build up balances abroad by purchasing claims to foreign currencies. They also sell those proceeds to the importers. They act as businessmen in buying and selling foreign currencies or claims to foreign exchange. Exchange Banks are those banks which deal with foreign exchange and have specialized in financing foreign trade. These banks are foreign banks and have their head offices located outside the country.

5.Co-operative Banks: Co-operative bank is an institution established on the co-operative basis and dealing in ordinary banking business. Like other banks, the co-operative banks are founded by collecting funds through shares, accept deposits and grant loans. In our country, Co-operative banks may broadly classified into a) Urban Co-operative Banks, b) Industrial Co-operative banks and c) Agricultural Co-operative Banks. Co-operative banks set up in urban

areas for the purpose of urban poor, small traders and handicrafts may be described as urban co-operative banks. Tirupati Town Co-operative Bank, Kavali urban Co-operative bank are the examples.

Co-operative banks started for the purpose of industrialists and manufactures are called industrial co-operative banks. E.g. Bombay Textile Mill Owners Co-operative Credit Society.

Co-operative banks purely meant for agriculturists in rural areas are called agricultural co-operative banks. E.g. District Central Co-operative banks (DCBs), State Co-operative banks (SCBs) etc.

6. Agricultural Banks: Banks which provide financial assistance to agricultural activities are called agricultural banks. In our country, there are no specialized agricultural banks as such. But many of the co-operative banks, all RRBs, and agricultural development branches (ADBs) of several commercial banks like SBI, are engaged in financing agriculturists.

7. Central Bank: An apex bank which regulates control and supervisor entire banking structure and regulates monetary stability in the country is know as Central Bank. It access bankers not only to all banks but also to the Government. It regulates the currency and trade systems. It serves as a lender of last resort. It acts as the control of credit. Reserve Bank of India (RBI) is the Central Bank of India. It performs many developmental functions and helps the economic development of the country.

8. Lead Banks: Lead Bank is a bank which is entrusted responsibility of surveying economic and banking potential in a district for preparing and implementing district credit plans.

9. Classification on the Basis of Ownership: On the basis of ownership, banks can be classified into three categories:

a) Public Sector Banks: These banks are owned and control by the Government. In India, the nationalized banks and the regional rural banks comer under these categories.

b) Private Sector Banks: These banks are owned and control by the private individuals or corporations but they have to follow the norms given by RBI.

c) Foreign Banks: These banks are foreign in origin but have branches in our country. After Narsimham committee recommendations and liberalisation of licensing policy many foreign banks opened their branches in India.

d) Local Area Banks: The banks are opened to meet the needs of local people are called Local Area banks. For example; Coastal Bank.

2.7 Summary:

A bank is a business firm which deals with money and credit. In the modern world, banks performs a variety of functions, which are divided into Primary functions and Secondary functions. The Primary functions are accepting the deposits form the public and advancing of loans. Secondary functions are functions of a non-banking character primarily for the convenience of its clients.These secondary functions are divided into Agency Services and

General Utility Services. Various systems of Banking like Unit Banking, Branch Banking, Mixed Banking, Investment banking, Group Banking and Chain Banking are explained in detail. Again different types of banks like commercial banks, Development banks, Agricultural banks, Exchange banks are also explained .

2.8 Key Words

1. SPNS - Shared Payment Network System
2. EFTPOS - Electronic Funds Transfer at Point of Sales
3. EFTS - Electronic Fund Transfer Services
4. DCBs - District Central Co-operative Banks
5. SCDs - State Co-operative Banks
6. ADBs - Agricultural Development Branches

2.9 Self Assessment Questions

Short Questions :

1.What is a bank?
2.Who is a banker?
3. Define banking according to Banking Regulation Act?
4.What are the types of accounts?
5.What is Branch banking?
6. Discuss the merits of Group banking?
7. What is a debit card?
8. What is a credit card?
9. State the primary functions of a commercial bank.
10. What are the agency services of a commercial bank?

Essay Questions :

1.. Give a brief description of functions of commercial bank
2 Explain the modern services of commercial bank..
3 .Distinguish between:
i} Unit banking and Branch banking
ii} Investment banking and Mixed Banking
iii} Group banking and Chain Banking
4. Explain the advantages and limitations of Branch Banking and Unit Banking
5.. Give an account of different types of banks.

2.10 Suggested Readings

1. Indian Financial System and Commercial Banking : The Indian Institute of Bankers.
2. Basava K.D. : Banking Theory and Practice, Vidyavahini Prakashana.
3. Srivastava P.K: Banking theory and Practice, Himalaya Publishing House

Dr. Uttama Durga Devi

Lesson 3

BANKING LEGISLATION AND REGULATORY FRAMEWORK

3.0 Objective :

The objective of this chapter is to explain the various acts passed under Banking Legislation and provisions come under these acts. The Regulatory Framework of the Banks like Licencing of the banks, Capital Reserves and Liquid Assets, Branch Licensing Policy, Inspection of Banks, Control over Management, Audit of Annual Accounts of Banks, Supervision of banks in liquidation and Credit Information Service is also explained.

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- **3.13.10 Credit Information Service**

3.14 Summary
3.15 Key Words
3.16 Self Assessment Questions
3.17 Suggested Readings

3.1 Need for Legislation:

From time to time attempts were made to attract the attention of the Government to enact a comprehensive legislation for protecting the interest of the depositors. There had been instances of maladministration of banks- like: i) combining trading with banking, ii) bad and speculative investments, iii) unrestricted loans to the Directors or to the industries/businesses in which the directors were interested, iv) injudicious advances, v) utilization of short-term funds etc. These unfair banking practices combined with dishonest management and inefficiency of the directors paved the way for many bank failures which brought untold agony to the depositors, particularly to the retired personnel, middle-class wage earners, small businessmen etc. Such sporadic bank failures necessitated the enactment of a separate banking legislation.

3.2 The Indian Companies (Amendment) Act, 1936:

The Central Banking Enquiry Committee felt that the provisions of the Companies Act governing banking companies were inadequate and recommended for the enactment of a comprehensive legislation. However, the foreign experts who were also the members of the committee favoured an amendment of the Indian Companies Act for the incorporation of their recommendations. As such the law relating to Banking companies was first enacted as Part X A of the Indian Companies Act with an amendment in 1936. Prior to this amendment, the banks were governed by the Indian Companies Act, 1913.

Some of the important provisions of the Indian Companies (Amendment) Act, 1936 (relating to banking) are:

1) Definition of a banking company.
2) Prohibition of banking companies from carrying on businesses other than specified in the definition.
3) Provision for a minimum paid-up capital (Rs.5 lakhs).
4) Restriction on Managing Agency System.
5) Provision for the maintenance of Reserve Fund and cash reserve by non-scheduled banks.
6) Prohibition of charge on unpaid capital.
7) Provision for the grant of moratorium by the court to a bank in temporary difficulties.

Although there were amendments in the Indian Companies Act, considerable difficulties were experienced by the administrators. Even the registrar of companies experienced difficulty in identifying a banking company as there was ample scope for ambiguity.

The Indian Companies Act was again amended in 1944 which contained the following important provisions:

1) No banking company incorporated on or after this 1st Jan., 1937 could carry on business unless its subscribed capital was not less than half of the authorized capital and the paid-up capital not less than half the subscribed capital.
2) The voting rights of all shareholders shall be proportionate to the shares held by them paid-up capital of the company.

3.3 The Banking Companies Act, 1949:

The enactment of the Banking Regulation Act in 1949 has been a milestone in the history of Indian joint stock banking. The long awaited comprehensive banking bill was introduced on March, 1948. This historical bill was passed and came into effect from March, 1949. Some of the important provisions of this Act are as follows:

IMPORTANT PROVISIONS

Definition of Banking:

The term 'Banking' or 'Banker' was not defined by any statute until the passing of the Indian Companies Act, 1936. Even the definition given in the Negotiable Instruments Act, 1881 was not satisfactory. According to Section 3 of the Negotiable Instruments Act, 1881, the term 'Banker' includes a person acting as a banker. This definition is a mere tautology saying the same thing in different ways without making one's meaning clearer or more forceful.

According to **Section 5 (c)** of the Banking Regulation Act, 1979, a 'Banking Company' means" any company which transacts the business of banking of India". Section 5(b) defines the word 'banking' as "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise." The above definitions reveal certain special characteristics:

1) A banker should accept deposits from the public with a view to lend them to others or to invest;
2) He should return the money to the depositors on demand or after some time, as per the agreement;
3) He should allow them to withdraw their money by cheque, draft or order. The banker, by himself, will not return the money to the depositors. This means that the depositor should demand payment as per the withdrawal procedure even in the case of fixed deposits.
4) The explanation of Section 5(c) of Banking Regulation Act states that any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing in business as such manufacturer or trader shall not be deemed to transact the business of banking.
5) In the same way, any one who carries on the business of lending alone cannot be termed as 'Banker'.

Section 6 of the Act lays down specifically the forms of business in which banking companies may engage. This section prohibits banking companies from taking part in trading and speculative activities, thereby landing themselves in danger. The importance of this section lies in the fact that one of the main causes that led to the failure of Indian joint stocks past during the early pert of their development was the varied nature of the transactions. The danger was clearly demonstrated in the case of the failure of the Indian Specie Bank in 1913.

Section 7 of the Act, as amended in 1963, prohibits the use of any of the words 'bank', 'banking' or 'banking company' to a company other than a banking company, or firms, individuals or group of individuals.

In case of change in the name of any banking company, the Central Government's approval is necessary. The central Government shall not give the approval to the change in name of any banking company unless the Reserve Bank of India certifies in writing that it has no objection of such a change.

Prohibition of Trading:

Section 8 prohibits a banking company form trading activities like buying or selling or exchanging of goods except in connection with the realization of security given to or held by it. In this context 'goods' means any kind of movable property, other than actionable claims, stocks, share, money, bullion and specie and all instruments referred to in clause (a) of sub-section (i) of Section 6. However, a banking company may buy or sell or barter for others in connection with:

i) Bill of exchange received for collection or negotiation; and
ii) Undertaking the administration of estates as executors, trustee etc.

Section 9 deals with disposal of non-banking asset. A banker is restricted from holding any immovable property except for his own use. He might also possess certain immovable property during the course of his business. If so such assets should be disposed off within seven years. However, the RBI may extend the term for another five years if it is satisfied that such extension would be in the interest of the depositors.

Section 10 prohibits employment of managing agents and places restrictions on certain forms of employment.

The Banking Company shall not employ or continue the employment of any of the following persons.

1. Who is or at any time has been adjudicated insolvent or has suspended payment or has compounded with his creditors or who is or has been convicted by a criminal court of an offence involving moral turpitude or
2. whose remuneration are part of whose remuneration takes the form of commission or of a share in the profits of the company.

Section 10 A specifies that Board of Directors to include persons with professional or other experience.

The Section provides that not less than 51% of the total number of members on the Board of Directors of a banking company shall consist of persons who satisfy the following conditions.

They shall have special knowledge or practical experience in respect of one or more of the following matters, namely: accountancy, agriculture and rural economy, co-operation, economics, finance, law, small scale industry, any other matter the special knowledge or practical experience in which would in the opinion of the Reserve Bank, be useful to the banking company.

Provided that out of the aforesaid number of directors , not less than two shall persons having special knowledge or practical experience in respect of agriculture and rural economy, co-operation or small scale industry.

They shall not have substantial interest in or be connected with, whether as employee, manager of;

a. any company not being a company registered under section 25 of the Companies Act 1956 or ,
b. any firm which carries on any trade commerce or industry and which, in either case, is not a small scale industrial concern, or be proprietors of any trading, commercial or industrial concern not being a small scale industrial concern.

Section 10 B provides that Banking Company is to be managed by a whole time Chairman.

Every banking company shall have a whole time chairman, who will be a professional banker and not an industrialist. He shall be entrusted with the management of the whole of the affairs of the banking company subject to the superintendence, control and guidance of the Board or Directors. His appointment shall be made by the banking company with the prior approval of the Reserve Bank. He shall hold office for a period not exceeding five years but shall be eligible for re-appointment.

A person shall be disqualified for being a chairman of a banking company, if he;

i) is a director of any company other than a) a company which is subsidiary of the banking company, b) a company registered under section 25 of the Companies Act.
ii) is a partner of any firm which carries on any trade, business or industry or
iii) has substantial interest in another company or firm or
iv) is a director, manager, partner or proprietor of any trading, commercial or industrial concern or,
v) is engaged in any other business or vocation.

The Act lays down certain important provisions regarding the minimum paid-up capital and reserves. According to the original provision **(Section 11)**, it was possible for a bank with only one place of business to be starter with as low a capital as Rs.50,000. In terms of the Amendment Act of 1962, the limit of minimum paid-up capital in the case of an Indian banking company commencing banking business for the first time after the commencement of the Banking Companies (Amendment) Act, 1962 is fixed at Rs.5 lakhs, irrespective of whether it has only one place of business or places of business in only one State.

It may be noted in this connection that according to the guidelines issued by the Reserve Bank of Indian in January 1993, the minimum-paid-up capital for the new private sector banks shall be Rs.100 crore. Similarly, according to the announcement made by the Bank in August 1996, the minimum paid-up capital of a local area bank shall be Rs.5 crore.

Regulation of Capital:

Section 12 brings the relationship between the authorized, subscribed and paid-up capital of a banking company. Accordingly, the subscribed capital should not be less than one-half of the authorized capital and the paid-up capital should not be less than one-half of the subscribed capital.

The maximum voting rights of any one shareholder if fixed by the Act, as amended in 1994, at 10 per cent of the total voting rights. This controls the concentration of power in any banking company in the hands of a few shareholders.

Interlocking directorates which pave the way for mismanagement are prohibited under the Act. According to **Section 16** of the Act, no banking company incorporated in Indian shall have as director any person who is a director of another banking company. The Act prohibits a banking company from making loans or advances on the security of its own shares; or granting unsecured loans or advances to any of its directors or to firms or private concerns in which the bank or any of its directors is interested as partner or managing agent.

Section **19** Banking Regulation Act, 1949 deals with the restriction on nature of subsidiary companies. In terms of sub-section 2 of Section 19, save as provided in sub-section 1, no banking company shall hold shares in any company, whether as a pledgee, mortagagee or absolute owner of an amount exceeding 30% of the paid-up share capital of that company, or its own paid-up sharecapital and reserves, whichever is less.

Section 21 of the Act confers powers on the Reserve Bank of India to determine the policy in relation to advances to be followed by banking companies. Sub-section (2) of that Section empowers the Reserve Bank to issue directions to banking companies as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances. This Section has been amended in 1963 so as to extend the powers of the Reserve Bank to give directions to banking companies regarding the maximum amount of advances that may be granted to or the maximum amount up to which guarantees may be given on behalf of any one company, firm, association of persons or individual.

Licensing of Banking Companies:

Section 22 of the Act requires every banking company to obtain a licence from the Reserve Bank for carrying on or commencing banking business in India. This is mainly intended to check the growth of unsound banks and to arrest the indiscriminate floatation of mushroom banks. The Reserve Bank before granting a license to any bank established before the commencement of the Act in 1949.The Reserve Bank is also empowered to cancel a license already granted.

The RBI will issue the license if it is satisfied with the following conditions:

a) A company is or will be in a position to pay its present or future depositors in full as their claims accrue. It means the liquid and other readily realizable assets must be sufficient to meet the claims of the depositors.

b) The affairs of the company are not being conducted in a manner detrimental to the interests of the present or future depositors.

c) The company has adequate capital structure and earning prospects.

d) The public interest will be served by the grant of a licence to the company to carry on banking business in India.

e) In the case of foreign banks, the Reserve Bank should be satisfied that carrying on of a banking business by the foreign bank is in the public interest and that the government of the country in which it has been incorporated does not discriminate against any banking company registered in India.

f) The RBI should also satisfied that –

(i) The company would carry on banking business in the public interest.

(ii) The Government or law does not the discriminate the banking company in any way: and

(iii) The company would comply with all the provisions of the law applicable to banking companies.

Opening of Branches:

Primarily any bank which intends to open a new branch door to transfer the existing place of business in India or outside India should obtain prior permission from RBI **(Section 23)**. But no permission is required for:

(a) A change of location within the same city, town or village (in India or abroad) and

(b) Opening of temporary place of business within a city for a maximum period of one month for providing banking facilities on the occasion of an exhibition, a conference or a mela or any other like occasion.

Powers to the Reserve Bank of India:

The Act of 1949, as amended in 1965, gives power to the Reserve Bank to regulate the appointment and remuneration of senior officers of banks. Further, the Amendment Act of 1956 has empowered the Reserve Bank to remove from office the Chairman or Chief Executive Officer of a banking company, if such a person has been found by any tribunal or any authority to have contravened the provisions of any law.

The Reserve Bank is empowered to inspect any banking company at any time to ensure itself about the efficient performance of the responsibilities of the banking company concerned. This is particularly useful to promote sound banking methods among the banking companies. It can call a meeting of the directors of a bank or change its management when disclosures arising out of inspection make such a step desirable.

The Reserve Bank is authorized to caution any individual bank or banks generally against a particular transaction or a class of transactions or to offer advice.

The Reserve Bank may , if it thinks necessary, apply to the High Court for the winding up of any banking company.

Section **35** of Banking Regulation Act 1949 deals with the inspection of the bank and submission of its report on inspection.

The Reserve Bank at any time either by itself or on being directed by the Central Government, shall cause an inspection to be made by one or more of its officers of any banking company and its books and accounts.

The Reserve Bank shall supply to the banking company, a copy of its report on such inspection.

Every director or other officer of the banking company shall produce all such books, accounts and documents as required by the Inspecting Officer.

Any person making inspection may examine on oath any director or other officer of the banking company.

If the Central Government, after considering the report is of the opinion that the affairs of the banking company are being conducted to the detriment of the interests of its depositors, it may, after giving an opportunity of being heard, to the banking company, may order in writing;

a. prohibit the banking company from receiving fresh deposits;
b. direct the Reserve Bank to apply under Section 38, for the winding up of the company.

Section 35A deals with the power of Reserve Bank to give Directions;

a) Where the Reserve Bank is satisfied that –

-in the public interest; or

-in the interest o f banking policy; or

-to prevent the affairs of any banking company being conducted in the manner detrimental
-to the interest to the depositors or

-in a manner prejudice to the interests of the banking company or

-to secure the proper management of any banking company generally;

it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

Section 35 B deals with Amendments of provisions relating to appointments of managing directors etc. to be subject to previous approval of the reserve bank.

Amendment of provisions relating to number of directors, remuneration, appointment, reappointment, termination etc. of Chairman, managing director or any other director or any chief executive shall not have effect unless approved by the Reserve Bank of India.

Similarly, any appointment, reappointment, termination of any of the above said officials of the company shall have effect only with the approval of the Reserve Bank of India.

According to **Section 36** of the Act, the Reserve Bank is required to make an annual report to the Central Government on the trend and progress of banking in the country, including its suggestions, if any, for the strengthening of the banking business throughout the country.

The provision relating to amalgamation of banks is an important one. The Act requires any scheme of amalgamation of banks to be approved by the Reserve Bank. The Reserve Bank, although encourages amalgamation among sound banking units, does not sanction any scheme of amalgamation is in the interest of the depositors, and the amalgamated unit will be able to play a useful role in the strengthening of the banking structure in the area of operation of the amalgamating units.

Section 36AA deals with power of Reserve Bank to remove managerial and other personnel from office.

Where the Reserve Bank of India is satisfied that the banking operations are conducted in a manner detrimental to the interests of the depositors and it is necessary to secure proper

management of the banking company. It may by order remove any chairman , director, chief executive or other officer or employee of the banking company.

Section 36AE deals with the power of central government to acquire undertaking of banking company. It provides that if on receipt of a report the central government is satisfied that a banking company.

a) has failed to comply with the directions given to it by the Reserve Bank relating to policy matters under section 21 and 35A or
b) is being managed in a manner detrimental to the interests of its depositors.

Section 37 of the Banking Regulation Act , 1949 deals with the Suspension of the Business. Sometimes the High Court may receive an application from a banking company stating that it is not able to meet its obligations temporarily. Then the High Court passes an order to staying the commencement or continuation of business of that banking company for some period. This temporary suspension of enforcement of liability against the company is called 'Moratorium' . The period of Moratorium shall not exceed six months in all. The High Court shall call for a report from the Reserve Bank on the affairs of the banking company.

Where the Reserve Bank is satisfied that the affairs of a banking company in respect of which a moratorium order has been made, are being conducted in a manner detrimental to the interests of the depositors, it make an application to the High Court for the winding up of the company . In case any such application is made the High Court shall not make any order extending the period for which the commencement or continuance of all actions and proceeding against the company were stayed under the moratorium order.

Section 44A deals with the procedure for amalgamation of banking companies. A banking company can amalgamate with another banking company only when a scheme containing such amalgamation has been placed before the shareholders of the two banking companies concern separately and approve by the resolution passed by a majority.

If the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of this section, it shall be submitted to the Reserve Bank for sanction. If the scheme is sanctioned by the Reserve Bank by an order in writing it shall be binding on the banking companies concerned and also on all the shareholders there of. On sanctioning the scheme of amalgamation by the Reserve Bank, the assets and liabilities of the amalgamated banking company shall become those of the banking company which under the scheme of amalgamation is to acquire the business of the amalgamated company.

Section 44B deals with the Restriction on compromise or arrangement between banking company and creditors. High court shall not comprise or arrangement between a banking company and its creditors in the detrimental of the interests of depositors of such banking company.

Where an application in respect of a banking company is made under Section 391 of the Companies Act, the High Court may direct the Reserve Bank of India to make an enquiry in relation to the affairs of the banking company and the conduct of its directors and when such direction is given, the Reserve Bank shall make such enquiry and submit its report to the High Court.

3.4 Banking Companies (Amendment) Act, 1960:

The Banking Companies (Amendment) Act, 1960 inserts a new **Section 34 A** in the Banking Regulation Act to make it clear that information, which according to law is not required to be published in the balance sheet or profit and loss account of a banking company need not be disclosed to the authorities set up under Industrial Disputes Act. However, the relevant authorities have been empowered to call for a certificate from the Reserve Bank regarding the amount of such reserves which may be taken into account for the purpose of the proceedings under the Act.

This amendment is intended to protect the Secrecy of the inner reserves of banks, which is important from the point of maintenance of the confidence of the depositors, while providing from an independent assessment of the magnitude of such reserve by the Reserve Bank.

Section 45 deals with the power of the Reserve Bank to apply to Central Government for suspension of business by banking company and prepare scheme of reconstruction or amalgamation. This section was introduced by the Banking Companies Amendment Act, 1960.

Where the Reserve Bank of India feels that there is goods reason for applying to Central Government for order of moratorium in respect of a banking company, it may do so.

The total period of moratorium shall not exceed six months. The banking company shall not during the period of moratorium, make any payment to any depositors or discharge any liabilities or obligations to any other creditors.

The Reserve Bank, if it is satisfied that-

a) in the public interest or
b) in the interests of the depositors or
c) in order to secure the proper management of the banking company or
d) in the interest of the banking system of the country as a whole, if it is necessary to do so, may prepare a scheme-
    i) for the reconstruction of the banking company or
    ii) for the amalgamation of the banking company with any other banking institution.

Section 45 R of the Banking Regulation Act deals with the submission of returns by the liquidator to the RBI showing the position of the banks in liquidation under their charge. These returns enable the bank to keep a watch on the progress of liquidation proceedings and the expenses of liquidation. The bank is also empowered to carry out the inspection of banks in liquidation to ascertain whether there has been any substantial irregularity in the winding up proceedings, if so directed by the Central Government or by the High Court. The reports on such inspections are forwarded to these authorities for necessary actions.

3.5 Banking Companies (Second Amendment) Act, 1960:

The Banking Companies (Second Amendment) Act, 1960 invests the Reserve Bank and the Government with additional powers aimed at rehabilitation of banks' difficulties.

The rehabilitation of a bank in difficulties would require a reasonable period of investigation and negotiation into its position. In order to ensure that during such a period the bank's position is not adversely affected, it is advisable to grant the bank a temporary moratorium. The amended Act provides that the Central Government may, on an application from the Reserve Bank, make an order up to a period of six months granting moratorium to a banking company. It is further provided that during the period of moratorium, the Reserve Bank may prepare a scheme for reconstruction of the banking company, if this is considered necessary, and submit it to the Central Government, who may sanction the scheme with necessary modification.

3.6 Banking Companies (Amendment) Act, 1961:

Subsequent to the failure of two scheduled banks in 1960, the Reserve Banks had taken powers to formulate and carry out, with the sanction of the Government, schemes for the reconstruction and compulsory amalgamation of sub-standard banks with well managed institutions. It also permits the amalgamation of more than two banking companies under a single scheme. The Act authorizes the Central Government to sanction such a scheme with or without modification and to bring it into force on the date specified by the Government. Provision was also made in the amendment to absorb the entire working staff on existing terms and conditions of service for a period not exceeding three years.

3.7 Banking Companies (Amendment) Act, 1962:

The Reserve Bank of India (Amendment) Act, 1962 and the Banking Companies (Amendment) Act, 1962 have come into force in September, 1962. The amendments were necessitated mainly by two considerations, viz., i) to strengthen the banking system; and ii) to enable scheduled banks to provide larges credit to exporters for a longer period.

The salient features of the amendments to both the banking Regulation Act and the Reserve Bank of India Act are summarized below:

Liquidity Ratio :

Section 24 of the Act as amended in 1962 requires every banking company to maintain in gold, cash or unencumbered securities, valued at a price not exceeding the current market price, an amount of not less than 25 per cent of its total time and demand liabilities instead of 20 per cent.. This provision is intended to ensure the liquidity of the assets of the banks. This Section is especially important since one of the main reasons which led to a number of bank failures in the past had been the negligence on the part of banks to maintain the liquidity of their assets in their greed to earn more profits.

The effect of the amendment is to split up the overall liquidity requirement of scheduled banks into two portions: i) statutory reserve balance required to be maintained under Section 42 of the Reserve Bank of India Act; and ii) cash or till money, gold, excess over statutory reserves, balances with the State Bank of India and with notified banks and unencumbered securities.

Statutory Cash Balances:

Section 42 of the Reserve Bank of India Act, which stipulates cash reserves of scheduled banks to be kept with the Reserve bank, has been simplified so as to require scheduled banks to maintain with the Reserve Bank an average daily balance of 3 per cent of their total time and demand liabilities. The cash reserve may now be varied between 3 per cent and 15 per cent.

Section 18 of the Banking Regulation Act was amended so as to require non-scheduled banks to maintain with themselves or in current account with the Reserve bank or its agencies, cash balance to the extent of 3 per cent of their total time and demand liabilities in India as against 5 per cent of demand and 2 per cent of time liabilities prior to the amendment.

Capital Funds:

The paid-up capital and reserves of commercial banks failed to keep pace with the increase in deposits brought about by the growing economic activity, with the result that the ratio of paid-up capital and reserves to deposits of scheduled banks steadily declined from about 9 per cent in 1950 to less than 5 per cent in 1960.

Under **Section 17** of the Banking Regulation Act, Indian banks were required to transfer to reserves 20 per cent of their balance of profit until the reserves together with the balance in the share premium account equaled with paid-up capital. In terms of the present amendment, a banking company incorporated in India is required to continue transferring to the reserve fund created under Section 17 of the Act even if the reserves have already equaled paid-up capital, out of the balance of profit each year, as disclosed in the profit and loss account and before any dividend is declared, a sum equivalent to not less than 20 per cent of such profit.

The amendment Act was necessitated as a result of the fact that the paid up capital and reserves of banks have not kept pace with the increase in deposits brought about by the growing economic activity during the past few years. It may be noted in this connection that with effect from the yea ending March 31, 2001 all scheduled commercial banks operating in India are required to transfer not less than 25 per cent of the net profit (before appropriations) to the reserve fund This transfer may be made after adjustment\provision towards bonus to staff.

Credit Information:

It was felt that in the absence of any regular and systematic arrangement for the collection, pooling and supply of particulars relating to the loans and advances or other credit facilities granted by the various banks and financial institutions to those borrowing from them, individual banks or financial institutions were handicapped in obtaining reliable information about the creditworthiness or financial position of the various persons/institutions to whom credit had been or may have to be granted.

With this end in view, the Reserve Bank of India Act was amended in 1962, providing **Sections 45C and 45D** incorporating Chapter IIIA, which empowered the Bank to collect information in regard to credit facilities granted by individual banks and notified financial institutions to supply information on application in a consolidated form. Accordingly, the Bank collects from the banks and notified financial institutions credit information on their borrowers who have been sanctioned secured limits aggregating Rs.5 lakhs and above and unsecured limits aggregating Rs.1 lakh and above. The information collected at present on a half-yearly basis relates to the name and address of the borrower, his occupation and type of organization, the type of account, the nature and description of the security, the limit sanctioned and the outstanding balance.

Export Finance:

The Reserve Bank of India Act, 1934 did not generally permit the Bank to make any loans or advances or to grant financial accommodation in any other form to commercial banks for periods

in excess of 90 days. It was also not possible for the Bank to make any such accommodation on the security of documents bearing only a single signature on behalf of any borrowing institution. In terms of the amended provisions:

a) The period of maturity of eligible bills of exchange and promissory notes which the Reserve Bank is authorized to purchase or rediscount or lend against is increased from 90 days to 180 days of the bills of exchange or promissory notes, as the case may be, relating to the export of goods form India.

b) The Reserve Bank is authorized to grant normal banking accommodation to the Scheduled Banks and State cooperative Banks for 180 days if the accommodation is for the purpose of financing exports.

3.8 The Banking Laws (Miscellaneous Provisions) Act, 1963:

With a view to restraining the control exercised by particulars groups or persons over the affairs of banks and to providing for stricter control over banks by the Reserve Bank, the Banking Laws (Miscellaneous Provisions) Act was passed in 1963. The Act amends the Reserve bank of India Act, the Banking Regulation Act and the State Bank of India (Subsidiary Banks) Act. The following are some amendments;

1. The prohibition on the use of any of the words ‘bank’, ‘banking’ or ‘banking company’ hitherto applicable to a company other than a banking company under Section 7 of the Act has been extended to firms, individuals or groups of individuals.
2. The amendment to Section 34 A extends to all banking companies the benefit of protection of the secrecy of information regarding their inner or undisclosed reserves, which was hitherto available only to banking companies with offices in more than one State.
3. The amendment to Sections 44 A and 45, relating to the reconstruction and/or amalgamation, and that copies of such order duly certified by an officer of the Reserve Bank or the Central Government, as the case may be, shall in all legal proceedings, be admitted as evidence to the same extent as the original orders.

3.9 Banking Laws (Application to Cooperation Societies) Act, 1966:

An important and growing element in the overall banking system, namely cooperative banks, was brought within the ambit of the Reserve bank’s statutory control under the Banking Laws (Application to Cooperative Societies) Act which came into force from 1 March 1966.

The Act extends to State Cooperative Banks, Central Co-operative Banks and the more important primary non-agricultural credit societies including, in particular, Urban Cooperative Banks, the provisions of the Reserve Bank of India Act and the Banking Companies Act, except those relating to incorporation, management and winding up which will continue to be governed by the State Cooperative Societies Acts. Section 35 of the Act empowers the Reserve Bank to inspect the cooperative banks either directly or through State Cooperative banks.

3.10 Deposit Insurance Corporation Act, 1962:

The main object of the Deposit Insurance Corporation Act is to give a measure of protection to depositors, especially small depositors, against the risk of losing their savings in the event of a bank’s inability to meet its liabilities and thereby assist banks in mobilizing deposits.

The Deposit Insurance Corporation has an authorized capital of Rs.1 crore which is fully paid-up by the Reserve Bank of India. The Act, under Section 26, empowers the Corporation to borrow from the Reserve Bank up to a maximum of Rs.5 crore.

In addition, the Corporation would maintain a General Fund, built up with the capital and reserves as well as income accruing from the investment of those funds, after meeting the working expenses of the Corporation.

The Deposit Insurance Fund would be applied:

a. to make payments in respect of insured deposits.
b. to meet liabilities in respect of an advance taken from the Reserve Bank under Section 26, and
c. to meet liability in respect of the amounts transferred to the Deposit Insurance Fund from the General Fund under Section 27.

The Corporation is required to invest its funds only in Central Government securities and treat the Reserves bank as its sole banker.

Management of the Corporation:

The general superintendence, direction and management of the affairs of the corporation are vested in a Board of Directors, consisting of:

a. The Governor for the time being of the Reserve Bank, who is the Chairman of the Board.
b. A Deputy Governor of the Reserve Bank nominated by the Bank.
c. An officer of the Central Government nominated by that Government.
d. Two directors nominated by the Central Government in consultation with the Reserve Bank, having special knowledge of commercial banking or of commerce, industry or finance, neither of whom is an officer of the Government or of the Reserve Bank or an officer or other employee of the Corporation or a director, an officer or other employee of a banking company or actively connected with a banking company.

The term of office of the first three directors is fixed by the respective authorities nominating them. The term of office of the non-official directors is limited to four years.

3.11 The Banking Laws (Amendment) Act, 1968 - Social Control Over Banks

The Banking Laws (Amendment) Act which amends the Banking Regulation Act, the Reserve Bank of India Act and the State Bank of India Act and which provides for the extension of social control over banks came into force with effect from February, 1969.

The objectives of the amendments to the Banking Regulation Act are mainly to achieve an equitable distribution of the resources of the banking system in conformity with the requirements of the country so that priority sectors receive their due and particular clients or groups of clients are not favoured.

The following are the more important provisions of the Act having a bearing on social control over banks:

1. Banks are required to reconstitute their Board of Directors, so that not less than 51 per cent of the total number of members having special knowledge in certain fields such as accountancy, agriculture and rural economy, small scale industry, cooperation, banking, economics, finance and law.
2. The Act empowers the Reserve Bank to reconstitute the Board of Directors of banks if the composition of the Board does not fulfil the requirements of law and the bank does not comply with the directions given by the Reserve Bank in this regard.
3. The Act requires every Indian bank to have a full time Chairman who is a professional banker and possesses experience in fiancé, economics or business administration. The Bank is also empowered to remove from office a Chairman of a Banking company and appoint a suitable person.
4. The Act prohibits the grant of any new loans and advances, whether secured or unsecured, to directors or members of any committee or Board appointed by the banks in India or to concerns in which they are interested as partner, director, manager, employee or guarantor or in which they hold substantial interest.
5. The appointment, reappointment or removal of the auditors of a banking company requires the approval of the Reserve Bank.
6. The Reserve Bank's powers to appoint directors or observers and to issue directions to banks have been amplified.
7. In view of the special responsibilities of banks under the Negotiable Instruments Act towards the depositors and the public in general, the Act provides a new Section which makes it unlawful to a) obstruct any person from lawfully entering or leaving a bank's office or from carrying on any business there, b) hold within such office, demonstrations which are violent or are calculated to prevent the transaction of normal business, or c) act in any manner calculated to undermine the confidence of the depositors in the bank concerned.
8. Under the Act, the Central Government is empowered to acquire the business of any bank, if it fails more than once to comply with any directions issued to it under Section 21 or Section 35 A of Banking Regulation Act in so far as such directions related to banking policy.

3.12 Banking Companies (Acquisition of Undertakings) Act, 1970 - Nationalisation of Commercial Banks

The Government of India Promulgated an Ordinance called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance on 19th July 1969, in terms of which the Central Government acauired the undertakings of the following 14 major Indian banks which had deposits of not less than Rs.50 crore each as on the last Friday of June 1969:

1. The Central Bank of India Limited,
2. The Bank of India Limited,
3. The Punjab National Bank Limited.,

4. The Bank of Baroda Limited,
5. The United Commercial Bank Limited
6. Canara Bank Limited,
7. United Bank of India Limited,
8. Dena Bank Limited.
9. Syndicate Bank Limited
10. The Union Bank of India Limited
11. Allahabad Bank Limited
12. The Indian Bank Limited
13. The Bank of Maharashtra Limited
14. The Indian Overseas Bank Limited

These banks together had []][opoptotal deposits of Rs.2471.76 crore. Together with State Bank of India and its subsidiaries, this constituted 85 per cent of the total deposits.

3.13 REGULATORY FRAME WORK

The following is the regulatory framework of banking system.

- Licensing of Banks
- Capital Reserves and Liquid Assets
- Branch Licensing Policy
- Inspection of Banks
- Control Over Methods of Operation
- Control Over Management
- Audit of Annual Accounts of Banks
- Control Over Amalgamations and Schemes of Arrangement And Reconstruction of Banks
- Supervision of Banks in Liquidation
- Credit Information Service

3.13.1 Licensing of Banks:

Licensing of the banks is mentioned under section 22 of the Banking Regulation Act. Hence any company which is willing to commence the banking business in India is required to go through this section has already been discussed elaborately in this chapter.

The banks in the public sector and the Regional Rural Banks are not required to obtain licence to undertake banking business in terms of either the Banking Regulation Act or the respective enactments namely, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 and the Regional Rural Banks Act, 1976.

3.13.2 Capital Reserves and Liquid Assets:

Sections 11, 17, 18, and 24 of the Banking Regulation Act, 1949 have prescribed the minimum requirements of capital reserves and liquid assets of the commercial banks which are given below:

1) paid-up capital and reserves, - Section 11
2) transfer to reserve fund , - Section 17
3) maintenance of cash reserves – Section 18

4) maintenance of other liquid assets – Section 24

The above sections have already been explained in this chapter.

The minimum paid-up capital and reserves laid down in Section 11 vary according to the geographical coverage of a bank's operations.

The requirement of minimum capital of the Regional Rural Banks is set to in the Regional Rural Banks Act. In terms of Sections 5 and 6 of that Act, each Regional Rural Bank has an authorized capital of Rs.1 crore and an issued (fully paid-up) capital of Rs.25 lakhs at the time of incorporation.

Scheduled Banks are enjoined to maintain cash reserves in terms of Section 42(1) of the Reserve Bank of India Act.

Non-Scheduled Banks are also expected to maintain cash reserves in terms of Section 18 of the Banking Regulation Act, 1949. In the case of Non-scheduled banks, they can keep this reserve either with themselves or with other banks in current accounts.

The present CRR is 10.5%.

Both scheduled and non-scheduled banks have to maintain liquid assets in the form of cash/gold/unencumbered approved securities to the extent of 25% as of now apart from the above CRR stipulation. This ratio is called Statutory Liquidity Ratio. The other aspects of SLR have been discussed already Section 23.

3.13.3 Branch Licensing Policy:

An important aspect of Reserve Bank's supervisory functions relate to the control exercised over expansion of bank's branches. Statutory powers to permit the opening of branches by commercial banks in India were first conferred by Banking Companies (Restriction of Branches) Act on the Reserve Bank of India. Substantive provisions of this Act were subsequently incorporated in Section 23 of the Banking Regulation Act which we have already discussed in this chapter.

Provisions Relating to Opening of New Banks /Branches:

The following are the provisions relating to opening of new branches (Besides section 22 and 23 Banking Regulation Act, 1949).

In order to introduce greater competition in the banking system, the Reserve Bank issued guidelines in January 1993 for the establishment of new banks in the private sector.]

The important guidelines in respect of the entry of new banks in the private sector apart from the required minimum paid-up capital of Rs.100 crore and the prudential accounting norms and the capital adequacy, etc. are:

a) Listing of their shares on stock exchanges,
b) Their management set-up, liquidity requirements, etc, to be governed by the provisions of the Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949, and also the directives, instructions/guidelines and advice given by the Reserve Bank,

c) Observance of directions in regard to priority sector lending with modification allowed in the composition of such lending for an initial period of three years,

d) Voting rights of an individual shareholder shall be governed by a ceiling of one per cent of total voting rights as stipulated by the Banking Regulation Act, 1949 (exemption, however, may be granted under Section 53 of the said Act to public financial institutions,

e) The new banks shall not be allowed to set up a subsidiary or mutual fund for at least three years after its establishment, and

f) The banks shall make use of modern infrastructural facilities to provide goods customer service as also institute a high powered customer grievances cell to handle customer complaints.

New private sector banks were permitted to open rural branches without insisting on the recommendations of Directorate of institutional Finance of respective State Governments. However they should accept the share of Annual Credit Plan if allotted by District Consultative Committee.

The Reserve Bank's Branch Licensing Policy for 1990-95 was changed in 1992 in response to the Narasimham Committee recommendations providing operational autonomy to banks to rationalize their branch network. Banks were permitted to shift their existing branches within the same locality, open certain type of specialized branches, convert the existing non-viable rural branches into satellite offices, spin-off business of a branch, and open extension counter/controlling officers/administrative units without prior approval of the Reserve Bank.

Banks which attained the stipulated capital adequacy norms and follow the prudential accounting standards were permitted to set up new branch offices/upgrade the extension counters into full fledged branches without the prior approval of the Reserve Bank.

In August 1993, banks were allowed to close (with the Reserve Bank approval), one loss making branch at rural centres served by two commercial bank branches (excluding RRBs) by mutual consent. Such proposals should have the recommendation of the concerned District Consultative Committee and the State Government.

In December 1993, RRBs were allowed to relocate their loss incurring branches at new places within their service area/area of operation.

New private sector banks which entered the banking sector in 1994 required to open 25 per cent of their total branches in rural/semi-urban areas.

In June 1994, Banks which attained a Capital Adequacy ratio of 8% earned net profit for three consecutive years, having NPAs not more than 15 per cent of total outstanding loans and a minimum owned funds of Rs.100 crore, were advised to submit to the Reserve Bank a plan of action for opening of new branches or to upgrade existing extension counters during the next one year for prior approval.

In June 1994, banks were advised to open at least one specialized Agricultural Finance Branch in each State to adequately deal with high-tech agricultural financing where they are convenors of the respective State Level Bankers' Committee.

In line with the Bhandari Committee's recommendation, the branch licensing policy for RRBs was modified in June 1995 as follows:

a. 70 RRBs were freed from the Service Area obligations and were given freedom to relocate their loss making branches preferably within the same block or convert them into satellite/ mobile offices;
b. Two loss making branches of the same RRB within five kms. area wee permitted to merge;
c. RRBs with Service Area obligations were free to relocate loss-making branches at "specified centres" within their area subject to the conditions cited above.

During the year ended March, 1996, public sector banks have operationalised 136 specialised branches in 85 identified districts and 33 specialised branches in other districts to cater to the needs of SSI units. With a view to continuing the tempo of opening more specialized SSI branches, banks were advised to operationalise 100 more specialized branches.

The banks which fulfil the criteria such as

(a) CRR at 8 per cent
(b) Minimum net owned funds at Rs.100 crore
(c) Net profit for 3 consecutive years
(d) Gross NPA not exceeding 15 per cent of total advances were given freedom to open branches.

Apart from these provisions relating to licensing of Commercial Banks and Regional Rural Banks, the Reserve Bank of India came out with a Licensing Policy in respect of urban Co-operative banks in 1993

The Banking Regulation Act 1949 applies to banks in the co-operative sector. Based on the recommendations of the Committee on Licensing of New Urban Co-operative Banks, (Marathe Committee) the Reserve Bank of India announced a revised registration/licensing policy for urban co-operative banks in May 1993. The liberalized policy encourages new entrants, subject to the fulfillment of capital adequacy and viability criteria. While allowing new urban banking institutions at a centre/area, existence of other banks in the co-operative sector only at those centres will be taken into account.

3.13.4 Inspection of Banks:

The most significant supervisory function exercised by the Reserve Bank is the inspection of banks. The basic objectives of inspection of banks are to safeguard the interests of the depositors and to build up and maintain a sound banking system in conformity with the banking laws and regulations as well as the country's socio-economic objectives. Accordingly, inspections serve as a tool for overall appraisal of the financial and managerial system s and performance of the banks, toning up of their procedures and methods of operation and prevention of serious irregularities. The inspection of banks has been mentioned under section 35 of the Banking Regulation Act, 1949 which is given in this chapter.

3.13.5 Control Over Methods of Operation:

Strict control is exercised by the Reserve Bank for ensuring that banks do not fritter away funds in improper investments and injudicious advances. These are discussed under section 8, 9, and 19(2) of the Banking Regulation Act 1949 which has discussed in this chapter.

3.13.6 Control Over Management:

The Banking Regulation Act, 1949 provide exercise control over the management of the Banking Companies. This is discussed in this chapter under section 10A, 10B, 35B, 36AA of the Banking Regulation Act.

3.13.7 Audit of Annual Accounts:

Banks have to close their books of accounts every year as at March, 31 and prepare a Balance Sheet and Profit and Loss account as prescribed in the III schedule to the Banking Regulation Act. These annual accounts are required to be audited by auditors appointed by the bank each year with the prior approval of the Reserve bank, as per Section 30 (1A) of the Banking Regulation Act, in respect of private sector banks.

Section 10(1) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 provides for audit of annual accounts of banks in the case of nationalized banks.

3.13.8 Control over Amalgamation and Schemes of Arrangement or Reconstruction of Banks:

Prior to 1960 amalgamations of banks could be brought about only in terms of Section 44A of the Banking Regulation Act on a voluntary basis. The results in respect of voluntary amalgamations effected before 1960, however were not encouraging considering the need for strengthening the banking system by eliminating the small and the weak units. To hasten the process of integration, additional statutory powers for the reconstruction or compulsory amalgamation of banks were acquired by an amendment of the Act in 1960. Since then, amalgamations are being brought about compulsorily wherever necessary and on a voluntary basis, wherever possible.

These provisions are contained in Sections 36AE, 44A, 44B and 45 which are discussed in this chapter.

3.13.9 Supervision of Banks in Liquidation:

It is the duty of the bank to safeguard the interests of the bank depositors at the time of liquidation of the bank. Amendments made to the Banking Regulation Act effective from December 1953 provide that, on an application being made by the Reserve Bank, the High Court may appoint the Reserve Bank or the State Bank of India or any other bank notified by the Central Government as the official liquidator of a bank; they also contain provision for the speedy disposal of winding up proceedings. Liquidators are required to submit to the Reserve Bank whenever called upon to do so, returns showing the position of the banks in liquidation under their charge. Section 45R of the Banking Regulation Act deals with supervision of banks in liquidation which is explained in this chapter.

3.13.10 Credit Information Service:

Sometimes one customer may take the loan from the different banks without repaying capacity. The banks usually do not exchange information with one another regarding credit facilities

sanctioned by them to their customers. Hence, Section 45C and 45D provide the information regarding the provisions of credit information service which is explained in this chapter.

3.14 Summary:

The Banking Legislation is needed mainly to protect the interests of depositors. Hence the Banking Regulation Act 1949 was introduced and various provisions under this act and the amendments made in 1960, 1961, 1962 and 1963 were discussed. Besides these Deposit jInsurance Acr 1962 and Amendment Acts for Social Control over Banks and Nationalisation of Commmercial Banks were also discussed. It was briefly explained the various dimensions of regulatory frame work of banking system like licensing of banks, Capital Reserves and liquid assets, Branch Licensing policy, Inspection of banks, Control over methods of operation and Management, Audit of Annual Accounts of banks, Supervision of Banks in Liquidation and Credit Information Service.

3.15 Key Words

1. Liquidity - The extent to which an organisation's assets are liquid
2. CRR - Cash Reserve Ratio
3. NPA - Non-performing Assets

3.16 Self Assessment Questions

Short Questions :

1.Trace the evolution of Banking Regulation Act, 1949.

2. Explain the sections 21 and 22 of Banking Regulation act

3. Specify any five provisions of the Banking Regulation Act, 1949, applicable to nationalized banks.

4.When a banking company be wound up?

6.Write a brief note on Banking Companies (Acquisition of Undertakings) Act, 1970 - Nationalisation of Commercial Banks

7.Write in brief the regulatory frame work relating to licencing branches

8. Explain Control over Management and Methods of operation.

Essay Questions :

1. What are the provisions Banking Regulation Act 1949.?
2. Explain the Regulatory Framework of Commercial Banks.

3.17 Suggested Readings

1. Banking Regulation Act,1949 (1997) Published by astern Book Company, Lucknow.
2. Tannan's Banking law and practice in India - 19th Edition (1997) India Law House, New Delhi.
3. Functions and working - Reserve Bank of India (1983) The Reserve Bank of India
4. Sekhar and Sekhar - The Financial System, Vikas Publications

Dr. Uttama Durga Devi

Lesson 4

BANKS AND ECONOMIC DEVELOPMENT

4.0 Objective

The objective of this chapter to review the commercial banks progress after nationalization. It is also explained how the commercial banks contribute for the economic development of the country.

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4.1 Introduction:

A strong and efficient system functionally diverse and geographical widespread is essential for accelerating the economic growth of the country. The nationalization of banks along with their 4130 branches, accounting for Rs.2,632 crores in deposits was hailed by many as revolutionary step that would lead to an optimal use of the financial mechanism of the country for the good of the masses, social justice and economic development. However, it looked like the actualization of the socialistic pattern vision of the ruling party which wanted to express its deep concern for the priority sectors like agriculture, small scale industries, as well as for professionals and others who had been denied the much needed elementary by the banking system for a long time. The nationalized banks were expected to give credit facilities to practically all the sections of the society belonging to the lower strata. According to Prof.S.V.Vasudavan, “In the modern economy,

banks are to be considered not as dealers in money, but as the leaders of development". Let us see how the Indian Commercial Banks helped for the economic development, social betterment, removal of economic backwardness and fulfill the goal of self-reliance.

4.2 Service to Trade and Industry:

Economic prospects of a country depend on the growth and development of trade and industry. Industrial development can take place only if sufficient money is invested in industries. In a developing country, supply of money is limited. Hence limited sources of money must be utlilised to the maximum possible use. Banks take up the responsibility of mobilizing savings of the people and lending the same to trade an industry. Credit creating capacity of the banks enable them to place large sums of money at the disposal of the nation's development activities. Cheques, drafts an letters of credit of banks enable trader to shift their funds from one place to another, banks enable trader to shift their funds from one place to another, further banks, also allow to discount bills of exchange, These bills and other documents will encourage both internal and external trade.

4.3 Credit to the Deserving:

Banks provide credit facilities to really deserving people and concerns. Further they grant loans to the manufacturers, whose products are in great demand. This helps manufacturers, to introduce new methods of production. This renders in raising national income of the country.

Table : 4.1

Loans and Advances of Commercial Banks (Rs. In crores)

Bank Groups	99-00	2001-02	2004-05
SBI Groups	129034	164589.4	284726.9
Nationalised	223076	316091.1	524530.9
PSBs	352110	480680.6	809257.7
Old Private	33586	42285.7	68184.04
New Private	22156	74144.43	152964.6
Foreign Banks	35617	48632.38	75318.25
SCBs	443469	961834.2	19149.82

Source:

1.IBA special Bulletin, 2001 various issues.

2.Performance highlights of public sector banks, 2004-05
Indian Bank Association.

The above table shows that deployment of credit of commercial banks has tremendously increased from 1999 -2000 to 2004-05. The credit has been increased from Rs.4,43,469 crores in 1999-2000 to Rs.19,14,982 crores in 2004-05. If the performance of bank groups are observed , it is found that there is tremendous increase in the advances given by different bank groups which leads to economic development.

4.4 Uniform Development of Different Regions:

Banks will be helpful in the matter of transferring of funds from one place to another. For a prospective and progressive industrialist, who wants to set up a factory I a backward area, banks

will be ready to extend their helping hand in the matter of financing. Money of surplus area will be diverted to backward area through banks for the purpose of investment and development. As Bagehot says, "the banks are a sort of standing brokers between the quiet, saving distinct and the active employing distincts". Commercial Banks have branches all over the country without showing any distinction among the regions and help for the balanced regional development. This can be shown in the below table:

Table : 4.2
Distribution of Banking Centres According to State and Population Group
(As at the End of March,2003 and 2004)

Population Group/ Region/State/ Union/ Territory	Rural		Semi-Urban		Urban		Metro-politan		All Centres	
	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
1	2	3	4	5	6	7	8	9	10	11
Northern Region	4536	4526	457	457	36	36	3	3	5032	5022
North-Eastern Region	1136	1134	123	122	10	10	-	-	1269	1266
Eastern Region	6914	6907	770	770	68	69	1	1	7753	7747
Central Region	7273	7252	808	808	60	60	4	4	8145	8124
Western Region	3652	3634	674	674	42	42	7	7	4375	4357
Southern Region	6261	6221	2210	2209	83	83	3	3	8557	8516
All India	**29772**	**29674**	**5042**	**5040**	**299**	**300**	**18**	**18**	**35131**	**35032**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, Volume-33 March, 2004.

For the convenience, the country has been divided into six regions and the banks has been started in all the six regions. The above table shows that banking centres were spread over in all the six regions which helps for the Balanced Regional Development.

4.5 .Business Expansion:

Banks provide advances to whole sale and retail business. This will help the businessmen to increase production, employment and sales, consequently, business will be expanded. Increased business activities will help for the economic development of the country. The following table shows the Banks Groupwise advances to Whole Sale and Retail business:

Table: 4.3

Banks Groupwise Advances to Business, March, 2004

(Rs. In lakhs)

Bank Group	Whole Sale	Retail
SBI Group	1307.65	2294.34
Nationalised Banks	1017.84	4809.31
Public Sector Banks	2325.49	7102.65
Private Sector Banks	704.18	1061.7

Foreign Banks	-	-
RRBs	104.68	694.63
Scheduled Commercial banks	3134.34	8860.38

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March, 2004.

4.6.Capital Formation:

Banks mobilise high rates of savings to secure their deposits. These deposits are invested in corporate securities of industrial concerns. These deposits lead for capital formation of the industries. The following table shows the loans given by the banks to various industries which will help for capital formation of those industries:

Table : 4.4
Outstanding Credit of Scheduled Commercial Banks to Various Industries March, 2004
(Amount in Lakhs)

Sl. No.	Industries	No. of Accounts	Amount Outstanding
1.	Mining & Quarrying	4,037	1861,06
2.	Food Manufacturing & Processing	12,701	5980,70
	a) Rice Mills, Flour & Dal Mills	5,048	799,00
	b) Sugar	333	1524,06
	c) Edible Oils & Vanaspati	962	538,22
	d) Tea Processing	589	1001,84
	e) Processing of Fruits & Vegetables	419	246,33
	f) Others	5,350	1871,25
4.	Beverage & Tobacco	1,099	14,79,62
4.	Textiles	12,671	10445,10
	a) Cotton Textiles	4,961	5783,70
	b) Jute & Other Natural Fibre Textiles	207	232,12
	c) Handloom Textiles & Khadi	732	128,55
	d) Other Textiles & Textile Products	6,771	4300,74
5.	Paper, Paper Products & Printing	5,224	2685,21
6.	Leather & Leather Products	931	291,31
7.	Rubber & Plastic Products	4,818	1884,00
8.	Chemicals & Chemical Products	5,367	9156,16
	a) Heavy Industrial Chemicals	961	2900,02
	b) Fertilisers	208	1902,31
	c) Drugs & Pharmaceuticals	1,163	1690,77
	d) Non-Edible Oils	107	21,25
	e) Other Chemicals & Chemical Products	2,928	2641,81
9.	Petroleum, Coal Products & Nuclear Fuels	455	4382,38
10.	Manufacture of Cement & Cement Products	1,326	3348,20
11.	Basic Metals & Metal Products	7,485	13466,15
	a) Iron & Steel	2,741	10379,60
	b) Non-Ferrous Metals	522	947,12
	c) Metal Products	4,222	2139,44
12.	Engineering	8,574	7577,17
	a) Heavy Engineering	2,139	1351,44
	b) Light Engineering	3,231	1554,30
	c) Electrical Machinery & Goods	1,982	2400,87

	d) Electronic Machinery & Goods	1,222	2270,57
14.	Vehicles, Vehicle Parts & Transport Equipments	2,349	4253,45
14.	Other Industries	42,054	8337,32
15.	Electricity, Gas & Water	1,257	13842,63
	a) Electricity Generation & Transmission	624	12891,23
	b) Non-Conventional Energy	193	249,09
	c) Gas, Steam & Water Supply	440	712,31
16.	Construction	47,790	17094,02
	Total	**1,58,138**	**106084,49**

The above table shows the advances given by the banks to the large scale industries. This will help the industries to increase their production which leads to growth in employment as well as national income of the country.

4.7.Social Service Schemes:

Banks are financing many schemes for the downtrodden people in the society and weaker sections to improve their social status and standard of living. By taking up the Village Adoption Scheme, Slum Removal Programme, Pollution Control Schemes and by framing and implementing several schemes for the upliftment of the downtrodden in the society, banks are participating in social service schemes in India. The following are various programmes adopted by the banks:

(i)Socio-economic and Poverty alleviation Programmes:

Government nationalized the banks to use them as an instrument for social change. For putting the economy on sound footing it is necessary that all sections of the society develop simultaneously. India with 51.5% people living below poverty line (1972-73-NSSO data) needed various programmes to fight the monster of poverty. Many poverty alleviation programmes have been implemented by the government during various periods. These programmes aim to eradicate the poverty from various ways. Some of the major poverty alleviation programmes are described below:

(ii)Differential Rate of Interest (DRI) Scheme:

The Differential Rate of Interest Scheme was started on 25th March 1972.

Objectives: The objectives of the scheme are a) making the interest rate mechanism subserve the objectives of social justice in the matter of distribution of credit and b) assist them in their efforts for economic well being through productive ventures by providing credit.

Area of Operation: The scheme is in operation all over the country. All banks and Regional Rural Banks will operate the scheme.

Statutory Norms: A minimum of 1 % of the total advances outstanding at the end of previous year should be lent under DRI. Atleast 40% of the advances should go to SC/ST persons. Not less than two third of the advances should be granted by rural/semi-urban branches. Interest under this scheme is 4% per annum plus interest tax. It will be given to the poorest of the poor.

Table: 4.5
Amount Outstanding Under Differential Rate of Interest Scheme

Year ended	Amount Outstanding (Rs. In Crores)	Percentage to total Advances
December, 1975	21	0.2
December, 1980	194	0.8
December, 1985	463	1.1
March, 1990	704	1.0
March, 1992	706	0.9

Source: Report on Currency and Finance, Publication by Reserve Bank of India various issues.

(iii)Integrated Rural Development Programme (IRDP):

The main objective of this programme is alleviation of poverty. This programmes is sponsored by the Central Government. It aims at all round development of target group to lift it above poverty line. It forms the core of the strategy of rural development. There is no limit for the loan under the scheme.

Table:4.6
Progress Achieved Under IRDP

Particulars	Target Achievement			
	1980-85	1980-85	1987-88	1989-90
Subsidy allocated (Rs. In Crores)	1500	1771.86	614.38	747.75
Subsidy utilized		1650.27	727.44	765.43
(Rs. In Crores)	3000	3101.61	1175.35	1220.53
No. of SC/ST families assisted (in Lakhs)	50.00	64.68	17.50	15.45
Total No. of families Assisted (in Lakhs)	151.30	165.62	42.47	34.51
Total No. of families to be assisted (in lakhs) (target)	-	151.30	39.64	29.08
No. of women beneficiaries Assisted (lakhs)	-	-	8.30	8.59

Source: Compiled from Report on Currency & Finance, Reserve Bank of India, various issues.

(iv)Special Component Plan:

It is centrally sponsored programme for providing assistance to SC/ST beneficiaries. SC/ ST Development Corporation in each state has been entrusted with the exclusive responsibility of preparing viable schemes for the socio-economic development of SC/ST persons. Subsidy and margin money assistance is provided by the corporations.

(v)Self-Employment Programme for Educated Unemployed Youth (SEEUY):

The main objective of this scheme was to encourage educated unemployed youth including women to take up self-employment ventures in industry, services and industry. The loan amount for industrial ventures is Rs.35,000 , Service ventures is rs.25,000 and Business ventures is Rs.15,000. Loans were repayable in 3 to 7 years with an initial holiday of 6 to 18 months. Subsidy to be claimed from Reserve Bank of India was 25% to be kept as term deposit in the bank and interest to be credited to the loan account.

Table:4.7
Amount Sanctioned Under SEEUY Programme

Year Ended	No. of Accounts ('000)	Amount (Rs. In Crores)
1983-84	242	402
1984-85	206	390
1985-86	221	430
1986-87	219	455
1987-88	120	260
1988-89	191	404
1989-90	97	190
1991-92	829	1734

Source: Complied from Report on Currency and Finance, Reserve Bank of India, Publication various issues.

(vi)Self-Employment Programme for Urban Poor (SEPUP):

This scheme excluded IRDP areas. The object of the scheme was to provide self-employment to the persons in the scheme areas. Loan amount was Rs.5000 with 25% subsidy. Interest on subsidy to be created to the loan account. Loan was repayable in 36 monthly intalments with an initial holiday of 3 months. Subsidy to be kept in fixed deposit to be adjusted on repayment of 75% of the loan amount.

Table:4.8
Amount Sanctioned Under Self-Employment Programme For Urban Poor (Introduced in September, 1986)

Year	No. of Accounts ('000)	Amount (Rs. In Crores)
1987-88	382	132
1988-89	357	137
1989-90	356	126
1991-92	1172	422

Source: Report on Currency and Finance, various issues, Published by RBI.

(vii)Scheme for Urban Micro Enterprises (SUME) :

This scheme is to provide support for setting up micro enterprises in order to self-employed opportunities for the urban unemployed and under employed persons with the help of subsidy and bank loan. The loan amount for SC, ST and women is Rs.15000 and for others is Rs. 12,000.

(viii)Prime Minister Rozgar Yojana (PMRY):

SEEUY was merged with this programme. At the district level District Industries Centre (DIC) headed by General Manager will coordinate the programme. Subsidy is to be kept as fixed deposit with nil interest. Loan amount net of subsidy should be taken into account for charging interest. If loan amount exceeds Rs.50,000, it is desirable that some permanent asset should be created, which can be taken as prime security. Minimum 36months repayment period is to be fixed for the loan.

(ix)Scheme for Liberation and Rehabilitation of Scavangers (SLRS):

Scavangers are the persons who are manually removing the night soil and filth. To liberate them from this degrading occupation and assist them to start some gainful venture. The scheme is centrally sponsored by the Ministry of Welfare and covers the areas all over the country. Maximum Loan amount is Rs.32,500.

(x)Prime Minister Integrated Urban Poverty Eradication Programme (PMI-UPEP):

This scheme was launched in the year 1996. With the launching of Swarna Yayanti Shahri Rozgar Yojana the PMI-UPEP has been merged with it on 1st December, 1997.

(xi)Swarna Jayanti Shahri Rozgar Yojana (SJSRY):

Swarna Jayanti Shahari Rozgar Yojana has been launched on 1st December, 1997 by the Ministry of Urban Affairs and Employment, Government of India. The SJSRY scheme consists of two special schemes. a) The Urban Self-Employment Programme (USEP), b) The Urban Wage Employment Programme (UWEP).

(xii)20-Point Programme:

This programme was launched on 1st July, 1975. This was first modified on January, 1982 and restructured again on 20th August, 1986 and was implemented since 1st April, 1987. This programme seeks to achieve four major objectives are a) to check inflation and ensure adequate supply of essential commodities, b) to uplift the downtrodden sections of the society by providing them economic and social justice, c) protection of consumers, and d) to offer responsive and co-operative administration.

(xiii)Area Oriented Programmes:

The launch of area oriented programmes began during 1970s focusing specific areas for various development purposes. Major thrust was given for the development of infrastructure in these programmes. These programmes were basically run by the government assistance. Banks assistance did not receive the prime importance in the implementation of such programmes. The major area oriented programmes are below:

a) Drought Prone Area Programme (DPAP): Due to insufficient rains, many parts of India are affected by drought frequently. Nearly 20% of the cultivated land in India is under persistent drought.

b)Backward Area Development Programme (BADP): The situation in backward areas cannot just be described as of comparatively less growth because in many areas the situation in worse than the stagnation due to negative growth. Hence these areas are to be treated separately. Industrial estates in backward areas could not succeed because of inadequacies of infrastructure and various other reasons.

c)Command Area Development Programme (CADP): Irrigation Commission (1971) after analyzing the reasons for under utilization of the irrigation potential suggested various measures to optimize the benefits of irrigated agriculture and emphasized for an integrated approach towards development of command area.

d)Hill Area Development Programmes (HADP): Under this programme, two central sector hill area development programmes were taken up on a pilot basis-one in Pauri Garhwal in Uttar Pradesh and the other one in Nungba in Manipur.The programme was further extended to Kangra district in Himachal Pradesh, Almora district in U.P. and Nilgri district in Tamilnadu.

The programme has the two aims , a) to maximize the agriculture production and to remedy imbalances existing between the different sections of the community and different regions of the country.

e)Desert Development Programme (DDP): The main aim of the programme is to check desertification. The development of productivity and productive resources of the area is also being done under the programme.

f)Tribal Area Development Programme (TADP): The position of majority of tribal population, in respect of essential needs of the life like food, water, clothing, housing, sanitation is relatively much worse than other communities. Hence special programme for the development of tribal people and tribal area was launched during the second plan period.

g)Whole Village Development Programme: The use of the package of practices for the village as a whole covering all the areas of development was the main concept of this programme.

(xiv)Productivity Oriented Programmes:

The main aim of the productivity oriented programme was to increase the productivity and production in agriculture and allied activities which was the main thrust of in the 1960s. Arrangement of all the inputs and infrastructure like improved seeds, fertilizer, manure, improved machinery, plant protection etc. was given importance in these programmes first. The activities are described below:

a)*Intensive Agricultural District Programme (IADP):* A team of agricultural experts sponsored by the Ford Foundation visited India in the year 1959 and gave 10 points for increasing food production. This programme culminated in Intensive Agriculture Area Programme.

b)Intensive Agricultural Area Programme (IAAP): The success of Intensive Agricultural District Programme prompted to start this programme in the year 1964 by covering 20 to 25% of the total cultivated area in 114 districts under this programme. Agricultural information centre was also set up to provide information to the farmers on the improved technologies.

c)High Yielding Variety Programme (HYVP): Wheat, Paddy, maize, jowar and bajra were the main crops selected for giving more emphasis under the programme. In the beginning programme covered 100 districts only but later on spread to other areas also.

d)Multiple Cropping Programme: The objective of this programme was to grow two or more crops in a year on the same tract of land increasing the cropping intensity of the particular land. Under this programme short duration crops like paddy, jowar, bajra, maize, oilseeds, potatoes etc. are grown.

e)Intensive Cattle Development Projects (ICDP): Intensive Cattle Development Projects and Key Village Blocks (KVB) programmes were implemented under the state sector and these constitute major cattle development programmes. 131 ICDPs and 550 KVBs covered nearly one fifth of the breedable cattles/buffaloes in various states and Union Territories.

f)Special Poultry Production Programme (SPPP): This programme aimed at supplementing the income of small/marginal farmers and agricultural labourers. Assistance was given to the farmers for rearing 50 bird units in 68 selected districts to cover 180000 farmers with an outlay of rs.18 crores.

g)Massive Agricultural Production Programme (MAPP) (1983-84): The objective of the programme is to provide assured source of water supply through well and pumpset to small and marginal farmers for increasing the production. Programmes also aims at the strengthening of similar minor irrigation, water management and land development measures.

h)Special Foodgrain Production Programme (SFPP) (1989-90): The objective of the programme was to increase the production level of 166 million tones in 1988-89 and 175 million tones in 1989-90 . Crops covered under the programme are paddy, wheat, maize, gramand arhar (red gram). Substantial amount of bank credit is involved in the programme.

i)Ganga Kalyan Yojana (GKY)(1st February, 1997): The scheme is centrally sponsored and 80% funding will be done by the Central and 20% by the state Governments. 50% of the funds are earmarked for the SC/ST. This scheme is to be implemented through DRDA/Zila Parishads. The objective of the scheme is to provide irrigation through exploitation of ground water through borewells and tube wells.

(xv)Employment Oriented Programmes:

Unemployment and under-employment is the main component of poverty in rural areas. This programmes may be either to provide self-employment like IRDP, SEEUY, SEPUP, SUME, etc., or to provide wage employment like NREP, RLEGP, EAS etc. At state level, various states level, varius states have formulated programmes for providing employment and reducing poverty like; Maharashtra- Employment Guarantee Scheme (EGS) in 1972, Rajasthan, U.P. and some other states- Antyodaya Scheme in 1977.

a)Pilot Intensive Rural Employment Programme (PIREP): This programmes started in the year 1972-73 during the Fourth Five year plan as a pilot project to find answer to the rural unemployment problem in India. The project aimed at providing employment to one third of the unemployed persons each year thus covering all unemployed persons in three years in the 15 selected blocks in the country situated in different economic and ecological conditions.

b)Crash Programme: This programme stared in the year 1971 to provide employment in rural areas. This programme was to three years with an allocation of Rs.150 crores. Under this programme road construction, land reclamation, protection from floods, minor irrigation etc. works were undertaken.

c)Food for Work Programme: This programme was launched in 1977 with the following objectives:

a) To provide opportunities of work for the poor persons living in the rural areas specially during the periods when there is no work in agriculture.

b) To utilize the available stocks of foodgrains and

c) To create durable infrastructure/assets for the villages in the form of roads, tanks etc.

This programme stamped success in rural areas by creating a large number of durable assets for the local communities. The programme was later on renamed as National Rural Employment Programme.

d)Minimum Needs Programme (MNP): To secure certain basic amenities like foodgrains, drinking water, health, education, house sites, electricity, roads, etc. within a reasonable time frame, the Minimum Needs Programme was introduced in the year 1972. Programme had a large outlay to help agricultural labourers and marginal farmers.

e)Training of Rural Youth for Self-Employment (TRYSEM): This programme stared on 15th August, 1979 as a centrally sponsored scheme. The main objective of this programe is to provide training in necessary skill and technology to the rural youth between the age of 18 to 35 years in agriculture, allied activities, industries, services and business.

f)National Rural Employment Programme (NREP): The genesis for this programme goes to the Food For Work Programme. National Rural Employment Programme was launched in October, 1980 by restructuring Food for Work Programme. It has been merged with Jawahar Rojgar Yojana.

g)Rural Landless Employment Guarantee Programme (RLEGP): This programme was launched in August, 1983 based on more or less Employment Guarantee Scheme of Maharashtra. The Programme has now been merged with Jawahar Rojgar Yojana.

h) Indira Kranthi Padham (IKP): This programme was introduced in 2004 by Dr. Rajashekar Reddy, Chief Minister of Andhra Pradesh. Under this scheme, training will be given to the rural youth and finance will be provided for self-employment .

(xvi)Jawahar Rozgar Yojana (JRY):

This programme was launched on 28th April 1989 and National Rural Employment Programme and Rural landless Employment Guarantee Programme have been merged with JRY. The programme is sponsored by the Central Government. The main aim is at providing wage employment to at least one member of each rural poor family for 50 to 100 days in a year near to his residence. The share of Central and State Government assistance was 80:20.

a)Nehru Rozgar Yojana (NRY): Nehru Rojgar Yojana is in operation since 11th October, 1989 and is the urbank counterpart of JRY. It aims at creating one million jobs in a year for urban poor by creating opportunities for self-employment as well as to generate wage employment.

b)Employment Assurance Scheme (EAS): This programme started on 2nd October, 1993 in 1778 development blocks of 23 states and union territories. Thereafter this programme was extended to include the areas under Drought Prone Area Programme, Desert Development Programme and flood affected areas. Now this programme covers 3198 development blocks of the country. The objective of the programme is to provide guaranteed employment, in the form of unskilled lablour, for 100 days in a year to the needy poor persons.

c)Rural Employment Generation Scheme of Khadi and Village Industries Commission (KVIC)- Margin Money Scheme: Set up in 1957 by an Act of Parliament The Khadi and Village and Industries Commission is entrusted with the responsibility of organizing, promoting, and implementing programmes for the development of the various industries like processing and preservation of fruits, bamboo, and cane works, oil Ghani, khadi cloths, palm gur, match boxes, leather tanning, hand made paper, non-edible oil and soap etc. It helps in providing self-employment to many persons in their own areas besides increase in production of the concerned raw- material.

Margin Money Scheme: The Margin Money Scheme (MMS) of KVIC is in operation for all viable village industry projects (except Khadi and polyvastra). The interest on bank loan has to be charged on the entire bank loan. Margin money will be one time assistance from KVIC and for any enhancement, the KVIC margin money will not be available.

(xvii)Target Oriented Programmes:

These programmes has specific target group as beneficiaries. Assistance is provided by the Government/financial institutions to these target groups for various development purposes. Some of the target oriented programmes are described below:

a)Small Farmers Development Agency (SFDA): Small farmers are those who own upto 5 acres of dry land or upto 2.5 acres of irrigated land. Their holdings are very small and uneconomic. On the basis of the Rural Credit Review Committee (1969) recommendations, the Small farmers Development Agency was set up in the year 1970. This programme has helped the small farmers all over the country in improvement of their economic condition.

b)Marginal Farmers and Agricultural Labourers Development Agency (MFALDA): Marginal farmers are those having upto 2.5 acres of dry land or upto 1.25 acres of irrigated land. Agricultural labourers are those who earn more than 50% of their wages from agricultural work. These programmes started in the year 1970 on the basis of recommendations of the Rural Credit Review Committee (1969).

c)Special Component Plan (SCP): The population of Scheduled castes in our country is 14.82 crores as per 1991 census. Indian constitution provides for educational, economic and social development of SC/ST and other backward sections of the people. The objective of this programme is that the financial assistance should be used for the development programmes of the scheduled castes persons, specially for the development of their business and to increase their productivity and income from their limited assets.

d)Antyodaya Programme: This programme was started in Rajasthan on 2nd October, 1977. The meaning of word "Antyodaya" is the last in the line. In other work we can say poorest of the poor. Antyodaya programme aimed at providing self sustaining economic independence to the poorest of the poor persons.

(xviii) Development of Women and Children in Rural Areas (DOWCRA):

Under this programme, Women will be formed into small homogeneous groups and they save money in the banks. These groups are called Self-Help Groups. And build their capacities to manage their own finances and then negotiate bank credit on commercial terms. The poor are encouraged and supported to voluntarily come together to save small amount of savings, called thrift regularly and extend micro loans among themselves to meet their emergent needs. Once the group attains required maturity of handling larger resources, the local Mandal Officers are the NGOs support the Self-Help Groups (SHGs) in getting bank loans. With these loans, the woman can start their own business and attain income on the business which will help them to improve their standard of living.

Table : 4.9
Bank Loans received by Self-Help Groups
(Amount in Rs.crore)

Promoting Group	**As on March 31, 2004**		**As on March 31, 2005**	
	No. (in '000) of SHGs	**Bank Loans**	**No. (in '000) of SHGs**	**Bank Loans**
1	**2**	**3**	**4**	**5**
I. SHGs promoted, guided and Financed by banks	217.62 (20)	550 (14)	344.37 (21)	1,013 (15)
II. SHGs promoted by NGOs/ Government agencies and Financed by banks	777.32 (72)	3,165 (81)	1,158.27 (72)	5,529 (80)
III. SHGs promoted by NGOs and Financed by banks using NGOs/ Formal agencies as financial Intermediaries	84.14 (8)	189 (5)	116.84 (7)	356 (5)
Total	**1,079.09**	**3,904**	**1,618.48**	**6,898**

Note: Figures in parentheses are percentages to total.
Source: Report on Trend and Progress of Banking in India, 2004-05, RBI Publication.

(xix)Scheme for Rural Artisans:

This scheme was launched in July 1992 as part of IRDP in few selected district and now is in operation in all the districts. The objectives of the scheme is to provide modern tools to artisans to make their products better and to increase the productivity and income.

(xx)Self-Employment Programme for Ex-Servicemen (SEMPEX):

Lakhs of our defence personnels retire every year in the prime of their youth. To provide self-employment to such personnesl, this scheme has been promoted by the Director General (Re-settlement). Subsidy of 34.3% of the project cost subject to a maximum of rs.3000 is available to them. An interest subsidy on the bank loan is also provided to them by the Kshetriya Sainik Boards.

(xxi)Preparing Ex-Servicemen For Self-Employment (PEXSEM):

This scheme was formulated by the Ministry of Defence, Government of India in the year 1983-84. The object of the scheme is to provide training, guidance and financial assistance to retired and retiring defence personnel to enable them to start a small self-employment venture in rural areas. The scheme is operational in select areas.

4.8 .Development of Weaker Sections:

Weaker Sections refers to those people who live below the economic poverty line and socially deprived classes of society. After nationalization, the RBI instructs the banks to priority sectors and weaker sections. The following table shows the advances of commercial banks to weaker sections:

Table:4.10
Advances of Commercial Banks to Weaker Sections
(As on March, 2005)

(Amount in Rs. Crore)

SL. No.	Name of the Bank	Weaker sections advances	
		Amount	Per cent to NBC
1	State bank Group	25,198.92	10.08
2	Nationalised Banks	38,294.19	5.2
3	Public Sector Banks	63,492.11	8.85
4	Private Sector Banks	1,914.86	1.2

Source: Report on Trend and Progress of Banking in India, 2004-05, RBI Publications.

The above table shows the SBI Groups advances more loans to weaker sections that is 10.08 per cent of net bank credit. Followed by public sector banks, nationalized banks and private sector banks which are 8.85 per cent, 5.2 per cent and 1.2 per cent respectively.

4.9.Advances to Priority sectors.:

Priority sector referred to those sector which have to be given priority in the matter of providing bank credit. At the time of nationalization of banks in 1969, those sectors included agriculture, small scale industry and exports. However, the concept of “priority sector” has been broadening to include new sectors identified for priority treatment by the Government of India from time to time. As such besides Agriculture, small scale industries, and exports, how it covers setting

up of industrial estates, road and water transport operators, retail trade, small business, professions and self-employed persons, education, housing of weaker sections etc. Thus the advance made to the above sectors constitute the total priority sector advances.

After nationalization of 14 commercial banks in India, the RBI has issued new guidelines to direct, greater flow of resources to priority sectors of the economy. In October, 1980, the banks were also asked to ensure that atleast 40 per cent of the additional credit of each year was disbursed to the priority sector. Subjected to the above some banks whose ration was found below 40 per cent, were required to disburse additional amount every year so as to progressively reach the target of 40 per cent by March, 1985. And the same as expected to be maintained thereafter.

Table : 4.11
Advances of Public Sector Banks to Priority Sector
(in per cent)

SL. No.	Name of the Bank	Percentage of Priority Sector Advances to Total Advances	
		2004	2005
1	2	3	4
1	Allahabad Bank	41.93	44.4
2	Andhra Bank	37.19	39.44
3	Bank of Baroda	27.88	28.26
4	Bank of India	28.07	28.34
5	Bank of Maharashtra	35.29	41.18
6	Canara Bank	34.9	34.74
7	Central Bank of India	44.52	44.78
8	Corporation Bank	35.85	34.75
9	Dena Bank	40.54	38.97
10	Indian Bank	38.2	42.93
11	Indian Overseas bank	39.13	39.16
12	Oriental Bank of Commerce	38.05	37.42
13	Punjab and Sind Bank	47.18	46.56
14	Punjab and National Bank	44.91	46.79
15	Syndicate Bank	32.57	36.27
16	UCO Bank	31.75	36.21
17	Union Bank of India	39.37	42.5
18	United Bank of India	34.91	34.97
19	Vijaya Bank	40.28	39.92
20	State Bank of India	27.04	28.59
21	State Bank of Bikaner and Jaipur	44.86	34.72
22	State Bank of Hyderabad	39.51	68.48
23	State Bank of Indore	46.32	44.98
24	State Bank of Mysore	36.52	24.12

25	State Bank of Patiala	39.39	44.04
26	State Bank of Saurashtra	42.67	17.62
27	State Bank of Travancore	37.22	6.92
	Other Public Sector Bank		
28	IDBI	0	0.51

Source: Performance Highlights of Public Sector Banks, 2004-05 (IBA).

It is clear from the above table that only ten banks have achieved the target of 40 per cent priority sector advances to total advances in 2003-04 and 2004-05. Because after reforms Narasimham Committee recommendations RBI is not particular about 40 per cent priority sector advances to total advances.

Table:4.12
Priority Sector Lending by Public and Private Sector Banks
(As at end-March)
(Amount in Rs. Crore)

Item	**Public Sector Banks**		**Private Sector Banks**	
	2003-04	**2004-05**	**2003-04**	**2004-05**
1	**2**	**3**	**4**	**5**
Priority Sector	**2,44,456 (44.6)**	**3,10,093 (44.2)**	**48,920 (47.3)**	**69,384 (44.3)**
of which :				
Agriculture	84,435 (15.1)	1,12,475 (15.7)	14,730 (14.2)	21,475 (12.1)
Small-scale Industries	58,311 (10.4)	67,634 (9.4)	7,590 (7.3)	8,668 (5.4)
Other Priority Sector	1,01,710 (18.1)	1,29,984 (18.1)	26,600 (25.7)	39,241 (24.5)

Note: Figures in brackets represent percentages to net bank credit for the respective groups.
Source: Report on Trend and Progress of Banking in India 2004-05.

It is clear from the above table that both the public sector banks and private sector banks have met the target of 40 per cent priority advances to total advances. The public sector banks have given more advances to agricultural and small scale industries compared to private sector banks.

Table : 4.13

Priority Sector Lending by Foreign Banks
(As on the last reporting Friday of March)
(Amount in Rs.crores)

Sector	2003		2004P		2005P	
	Amount	Percentage To net Bank credit	Amount	Percentage to net bank credit	Amount	Percentage to net bank credit
1	2	3	4	5	6	7
Priority Sector Advances #	**14,555**	**34.1**	**17,960**	**34.1**	**23,886**	**35.4**
Of which:						
Export Credit	8,276	18.8	9,760	18.5	11,942	17.7
Small-scale Industries	4,010	9.1	5,307	10.1	6,914	10.3

P: Provisional

#: Inclusive of advances to setting up industrial estates, funds provided to RRBs by sponsor banks, loan to software industries, food and agro-processing sector, self-help group and venture capital.

3 For public and private sector banks, sub-targets of 18 per cent and 10 per cent of net bank credit have been specified for lending to agriculture and weaker sections, respectively.
4 For foreign banks, sub-targets for lending to the SSI sector and export sector have been specified at 10 per cent and 12 per cent, respectively.

Source: Report on Trend and Progress of Banking in India 2004-05.

The above discloses that foreign banks gives advances to only exports and small scale industries. Their advances to priority to priority sector to total advances are 34.1 per cent and 35.4 per cent in 2004 and 2005 respectively. They have not given advances to agriculture.

4.10. Aid for Agriculture:

Banks help agriculture with their financial assistance. Loans are given for purchasing seeds, for developing land, for purchasing fertilisers and others, at concessional rates of interests for small an marginal formers. Further several banks are running farmers service societies for technical service to the farmers.

Direct finance to agriculture and allied activities is expected to reach a level of 17 per cent of rural credit by March, 1989. In February 1989, this target was further raised to 18 per cent to be achieved by March, 1989.

A target of 10 per cent of net bank credit for weaker sections i.e., small and marginal farmers, share croppers, tenant farmers, landless labourers, artisans, village and cottage industries, IRDP beneficiaries, SC/ST borrowers etc., should be maintained. The following table shows the Advances to Agriculture by Public and Private Sector Banks at the end of March, 2005:

Table:4.14

Advances of Private and Public Sector Banks to Agriculture (as on March, 2005)

SL.No.	Name of the Bank	Direct Agricultural Advances		Indirect Agricultural Advances		Total Agricultural Advances	
		Amount	Per cent to NBC	Amount	Per cent to NBC	Amount	Per cent to NBC
1	2	3	4	5	6	7	8
1	Public Sector Banks	82,612.93	11.52	29,862.02	4.16	1,12,474.95	15.68
2	Nationalised Banks	55,635.19	11.91	23,544.52	5.04	79,178.71	16.41
3	State Bank Group	26,977.74	10.79	6,318.50	2.53	33,296.24	14.32
4	Private Sector Banks	12,157,012	7.59	9,315.51	5.82	21,472.63	12.09
	Total	**12,322,237.86**	**41.81**	**69,039.55**	**17.55**	**133,947.58**	**57.50**

The above table shows the Agricultural advances given by Public Sector Banks and Private Sector Banks. The direct agricultural advances given by public sector banks are 11.52 per cent of net bank credit where as the loans given by private sector banks are only 7.9 per cent of net bank credit. At the same time, indirect agricultural advances provided by private sector banks are more than advances provided by public sector banks. This shows that public sector banks are providing more advances to direct agricultural whereas private sector banks are providing more advances to indirect agricultural activities.

Table : 4.15

Flow of Institutional Credit to Agriculture

(Rs.crore)

Agency\Years (Estimated)	19997-98	1999-2000	2002-03	2003-04	2004-05
Co-operative Banks	14,085	18,363	24,296	26,959	30,638
RRBs	2,040	3,172	5,467	7,581	11,718
Commercial Banks	15,831	24,733	41,047	52,441	72,886
Total	**31,956**	**46,268**	**70,810**	**86,981**	**1,15,243**

Source: NABARD

Source: Report on Trend and Progress of Banking in India 2004-05.

The above table shows that commercial banks provide more advances to agriculture followed by co-operative banks and RRBs.

4.11 .Advances to small scale industries:

Agriculture and Small Scale industries are the two most components of the priority sector lending policy. A committee by the RBI under the chairmanship of P.R. Naik, the Deputy Governor

of RBI to examine the difficulties faced by the SSI units in securing the institutional credit. It submitted its report in August, 1992. The following are some of the committee recommendations:

1. The banks should take step to ensure full adherence of the RBI guidelines in financing for working capital for SSI.

2. The Committee observed that the SSI sector as a whole received a level of working capital to the extent of 8.1% of its output. Among them, the village and cottage industries got 2.7% while large units received 18.8 per cent. Banks should give priority to village and cottage industries and tiny industries which can use the working capital efficiently, having established production successfully but unable to make further progress due to lack of working capital.

3. The new priority sector credit dispensation, when adequate, should fully provide for the orking capital segment of all tiny units up to credit limit of Rs.10 lakhs after taking care of the working capital for village and cottage industries and tiny industries of credit limit of up to Rs.1 lakh.

4. Working capital limits have to be arrived on the following basis for advances to SSI up to Rs.50lakhs (RBI has increased it to Rs.1 cr.)

i) Twenty five per cent of the output value has tobe computed as the quantum of working capital required by the units.

ii) Four fiths (20%) of the above should be financed by the bank as working capital limit. One fifth (5%) is to be brought in by the unit as margin.

5. Four types of loan application forms are recommended:
a) For total advances up to Rs.2 lakhs (including composite loans)
b) For total advances above Rs.2 lakhs and up to Rs.15 laksh.
c) For total advances above Rs.15 lakhs and up to Rs.1 crore.
d) For total advances above Rs.1 crore.

Table:4.16
Advances of Commercial Banks to Small Scale Industries
(As on March, 2004)

(Amount in Lakhs)

Bank Group	Village and Tiny Industries	Other Small Scale Industries
SBI Group	2345.81	9265.25
Nationalised Banks	1570.79	24157.21
Public Sector Banks	3916.6	33422.46
Private Sector Banks	144.31	4071.4
Foreign Banks	46.88	670.99
RRBs	804.32	341.99
Scheduled Commercial banks	4912.12	38432.55

Source; Basic Statistical Returns of Scheduled Commercial Banks in India, RBI , March, 2004

4.12.Encouragement for Foreign Trade:

Banks provide financial facilities to traders doing foreign trade by the supply of letters of credit, travellers, cheques, circular notes and providing discount facility for foreign bills of exchanges. Further, some banks furnish very much valuable information on trade abroad to their customers. Foreign trade especially export trade, in its turn helps for the economic development of the country. Accommodation by the Reserve Bank to Schedule Commercial Banks for export credit refinance.

Table:4.17

Accommodation by the Reserve bank to Scheduled Commercial Banks

(Amount in Rs. Crore)

As on the last reporting Friday of	Limit	Total Export Credit Refinance Outstanding	Others		Total	
			Limit	Outstanding	Limit	Refinance Outstanding
1	2	3	4	5	6 (2+4)	7 (3+5)
2003 March	5,048.26	84.51	399.66	-	5,447.92	84.51
2004 January	4,822.60	-	399.66	-	5,222.26	-
February	4,761.57	-	399.66	-	5,161.23	-
March	4,664.42	-	399.66	-	5,064.08	-
April	4,894.62	-	399.66	-	5,294.28	-
May	5,051.83	420	399.66	399	5,451.49	819
June	4,464.44	-	399.66	-	4,864.10	-
July	4,321.96	-	399.66	-	4,721.62	-
August	4,305.84	2.5	399.66	-	4,705.50	2.5
September	4,375.61	2.7	399.66	-	4,775.27	2.7
October	4,437.55	-	399.66	-	4,837.21	-
November	4,600.52	7.5	399.66	-	5,000.18	7.5
December	4,614.82	601.29	399.66	-	5,014.48	601.29
2005 January	4,800.05	-	399.66	-	5,199.71	-
February	4,864.82	-	399.66	-	5,264.48	-
March	4,912.13	50	399.66	-	5,311.79	50
April	5,169.37		399.66	-	5,569.03	-
May	4,914.86	774	399.66	-	5,314.52	774
June	4,884.20	-	399.66	-	5,284.86	-
July	4,920.95	-	399.66	-	5,320.61	-
August	4,744.02	474.13	-	-	4,744.02	474.13
Septermber*	4,814.52	6	-	-	4,814.52	6

- : Nil / Negligible.

* : Up to September 02,2005

Note: Total limits under normal and back-stock facility merged into singly facility with effect from March 29,2004.

Source; Report on Trend and Progress in Banking in India, 2004-05.

The above table shows the refinancing of RBI to Commercial Banks which will help the Commercial Banks to lend advances to foreign trade.

Bank finance to Exports: In the case of Export business, the following schemes were introduced and these schemes were financed by the banks:

(i)Packing Credit Guarantee:

It covers, Packing credit advances, including running account facility given to exporters. Banks can obtain this guarantee cover on case to case basis, which is called 'Packing Credit Guarantee' (PCG) or on Whole turn over basis, which is called 'Whole turnover packing credit guarantee' (WTPCG). Generally banks prefer to take WTPCG as it has some favourable features compared to individual packing credit guarantee.

(ii)Export production finance guarantee:

Sometimes, the cost of production exceeds the FOB value of export contract/order in case of certain commodities and the difference is compensated by government as incentives. In such cases the packing credit availed will be more than the amount of export contract/order itself. In such cases, banks sanction packing credit covering incentives part of it also and such portion is covered under "Export Production Finance Guarantee".

(iii)Post Shipment Export Credit Guarantee:

Post-shipment finance given to exporters by banks through purchase, negotiation or discount of export bills or advances such bills qualifies for this Guarantee. It is necessary, however, that the exporter concerned should hold suitable policy of ECGC to cover the overseas credit risks. Bank can obtain this guarantee on individual account basis or on whole Turnover basis which is called Whole Turnover Post Shipment Credit Guarantee (WTPSCG).

(iv)Export Finance Guarantee:

It covers post shipment advances granted by banks to exporters against Government incentives receivables from Government in the form of cash incentives or duty draw back etc. The premium is 7 paise per Rs.100 per month and the cover available is 75% of loss. Banks having WTPCG/ WTPSG are eligible for concessional premium premium rate and higher coverage.

(v)Export Performance Guarantee:

Exporters are often called upon to execute bonds like bid bonds, performance guarantees, advance payment guarantees duly guaranteed by a Bank in India at various stages of export performance. ECGC provides export performance guarantee to banks to protect them against losses they may sustain by issuing such guarantees, thus encouraging banks to give guarantees on liberal basis for export purposes.

(vi)Export Finance (Overseas Lending) Guarantee:

If a bank financing an overseas project provides a foreign currency loan to the contractor, it can protect itself from the risk of non-payment by the contractor by obtaining Export Finance (Overseas Lending) Guarantee.

4.13 .Housing Finance:

The basic needs of mankind have been the food, shelter and clothing. Keeping this in mind, lots of efforts have been made to provide food through the poverty alleviation programmes since substantial portion of the Indian population are still in the clutches of abject poverty. The

poverty alleviation programmes are both credit oriented and non-credit oriented. Housing , as such, in any country depends on the following factors:

Demand factors - Growth in population, formation of households, development of new townships, and increase in income.
Supply factors - Availability of institutional credit, cost of construction, availability of land and building materials, and fiscal and legal provisions affecting building construction.

Though both the type of factors play their role equally, it is to be understood that everyone wants to have a house constructed either through own money or borrowed funds. But the growing population makes it impossible to construct houses and satisfy this need for all the people in desired proportions.

Housing Finance: Institutions, Schemes and Support:

The National Housing Policy, to be success, presupposes the existence of proper institutional set up, realistic development and credit schemes and the reasonable credit support. The institutions are the following:

a. National Housing Bank
b. Commercial Banks and their Housing Subsidiaries.
c. Life Insurance Corporation of India
d. Housing & Urban Development Corporation.
e. Housing Development Finance Corporation Limited etc.

Home Loan Account Scheme:

A contractual deposit scheme linked to guaranteed loan from scheduled banks was introduced on 1 July, 1989. It has a two pronged strategy to mobilise household savings and to increase the flow of credit for housing. Under this, scheme, an individual person can save specifically for housing and secure long-term institutional finance on the basis of accumulated savings for a period of five years. A loan under the scheme will not bar a loan from any other source including that from a bank on usual terms. In the VIIIth PIAN, till June 1995, more than 7 lakh accounts have been opened under the Home Loan Account and Rs.374.14 crores have been mobilized as savings.

Table:4.18
Advances of Commercial Banks to Housing Loans, 2004

(Rs. In Lakhs)

Bank Group	Housing Loans
SBI Group	21248.59
Nationalised Banks	34156.14
Public Sector Banks	55404.73
Private Sector Banks	22322.45
Foreign Banks	5705.76
RRBs	1914.5
Scheduled Commercial banks	85346.45

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, RBI , March, 2004

4.14.Development of Rural and Semi- Urban Areas:

One of the objectives of nationalization are extension of banking facilities to rural areas. After 1969, there is a significant growth in the rural branches of banks. The number in rural areas having population up to 10,000has increased from 1832 in June 1969, to in March 2005. This is explained in the following table:

Distribution of Branches of Public Sector Banks 2004-05

SL. No.	Name of the Bank				Branches					Total	
			Rural	%	Semi-Urban	%	Urban	%	Metro-politan		%
	%										
1	2	3	4	5	6	7	8	9	10	11	12
1	Allahabad Bank	970	50.26	323	16.74	389	20.16	248	12.85	930	100
2	Andhra Bank	380	34.84	316	28.14	274	24.40	153	14.62	1123	100
3	Bank of Baroda	1160	44.28	558	20.82	476	17.76	486	18.13	2680	100
4	Bank of India	1237	48.49	489	19.17	423	16.58	402	15.76	2551	100
5	Bank of Maharashtra	542	24.77	233	10.22	242	10.61	263	11.54	2280	100
6	Canara Bank	760	30.17	683	27.11	551	21.87	525	20.84	2519	100
7	Central Bank of India	1381	44.12	760	24.28	556	17.76	433	14.83	3130	100
8	Corporation Bank	178	24.15	143	18.60	214	27.83	234	30.43	769	100
9	Dena Bank	392	37.62	215	20.63	192	18.43	243	24.32	1042	100
10	Indian Bank	468	34.19	351	25.64	321	24.45	229	16.73	1369	100
11	Indian Overseas bank	527	34.67	374	24.61	337	22.17	282	18.55	1520	100
12	Oriental Bank of Commerce	253	22.23	302	26.54	323	28.38	260	22.85	1138	100
13	Punjab and Sind Bank	294	38.79	110	14.51	218	28.76	136	17.94	758	100
14	Punjab and National Bank	1930	48.19	802	20.02	752	18.78	521	14.01	4005	100
15	Syndicate Bank	648	35.66	421	24.17	402	22.12	346	19.04	1817	100
16	UCO Bank	775	44.80	336	19.42	333	19.25	286	16.53	1730	100
17	Union Bank of India	793	38.68	469	22.88	439	21.41	349	17.02	2050	100
18	United Bank of India	645	49.39	203	15.54	248	18.99	210	16.08	1306	100
19	Vijaya Bank	255	28.02	203	22.31	245	26.92	207	22.75	910	100
20	State Bank of India	4068	45.02	2475	27.39	1470	16.27	1023	11.32	9036	100
21	State Bank of Bikaner and Jaipur	313	38.50	229	28.17	133	16.36	138	16.97	813	100
22	State Bank of Hyderabad	290	31.69	285	31.15	202	22.08	138	15.08	915	100
23	State Bank of Indore	132	30.14	132	30.14	64	14.61	110	25.11	438	100
24	State Bank of Mysore	213	79.78	149	55.81	116	44.45	149	55.81	267	100
25	State Bank of Patiala	277	37.18	211	28.32	170	22.82	87	11.68	745	100
26	State Bank of Saurashtra	140	34.49	136	32.54	69	16.51	73	17.46	418	100
27	State Bank of Travancore	47	7.03	463	69.21	110	16.44	49	7.32	669	100

This table shows that in all the banks most of the branches are established in rural areas. For example in the case of Allahabad bank, out of the total number of branches, 77 percent are established in rural and semi-urban areas. In the same way Bank of India, 67.66 per cent of branches are established in rural and semi-urban areas.

Conclusion:

The purposes of nationalized banks were to promote rapid growth in agriculture, small scale industries and exports, to encourage new entrepreneurs and to develop all backward areas. A review of three and half decades of nationalization of commercial banks indicates that nationalization is a change of both form and substance as far as a monitor system of country is concerned. Nationalised banks have contributed for the economic development of Indian economy as a whole for the last few decades. The effectiveness of nationalized banks have been justified so far by the progress of various banking activities like extension of credit, credit to priority sectors, and extension of banking services to the rural and semi-urban areas. We do hope that nationalized banks could be able to play more positive role in the changed circumstances and help for more economic development.

4.15 SUMMARY:

Nationalised banks have contributed for the economic development of Indian economy as a whole for the last few decades. They have helped for the development of agriculture, small scale industries and exports, to encourage new entrepreneurs and to develop all backward areas. Banks have introduced many Social Service Schemes like Integrated Rural Development Programme, TRYSEM,NREP and many programmes for weaker sections and Rural Artisans. Banks had started branches in rural and semi-urban areas and helped for the development of rural areas. They have participated in the empowerment of women, by giving the loans under DWACRA Scheme and Indira Kranthi Pathakam. Thus banks play an important role in the economic development of a country.

4.15 Key Words

1. IRDP - Integrated Rural Development Programme
2. DRI - Differential Rate of Interest
3. EFG - Export Finance Guarantee

4.16 Self Assessment Questions

Short Questions :

1. How the banks help for the Balanced Regional Development?
2. What is priority sector?
3. What is IRDP?
4. Give an account of Social Service Schemes of a bank.
5. How the banks contributed for the unemployed youth?
6. How the banks contributed for the empowerment of women?
7. Explain the contribute for the development of agriculture.
8. Explain how the banks help for Small Scale Industries.
9. Explain various banking schemes for weaker sections.

Essay Questions :

1 Give an account of banking advances to priority sector.

2. How the banks help for the development of the rural sector?

3.Explain the role of commercial banks in the economic development of our country.

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4.17 Suggested Readings

1. IBA Bulletin Special Issue, January, 2005.

2. Report on Trend and Progress of banking in India, 2005

4. Mithani D.M. and Gordon E. Banking and Financial System, Himalaya Publishing House

Dr. Uttama Durga Devi

Lesson 5

BANKING SECTOR REFORMS

5.0 Objective

The objective of this chapter is to enlighten the importance of Narasimham Committee reforms and important recommendations made by the committee. There is also need to explain the need for and impact of second phase of reforms. The profitability after reforms is also explained in detail.

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5.1 Introduction

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- **5.9.1 Structural reforms**
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5.10 Profitability after Reforms

5.11 Summary

5.12 Key Words

5.13 Self Assessment Questions

5.14 Suggested Readings

5.1 Introduction

After independence, Indian Banking System has recorded rapid progress, due to planned economic growth, increase in money supply, growth of banking habit, control and guidance by the RBI and above all nationalisation of banks in July, 1969. Bank was considered a reliable institution for holding savings and as a major lender of funds. Banks have been undergoing

considerable transformation since the last sixties. With nationalisation of banks, the era of social banking began, wherein rural and semi-urban bank branches predominated, side by side with social lending targets. There is wide improvement in the branch expansion, deposit mobilisation, deployment of credit to priority sector, improvement of agriculture and small scale industries, and promotion of foreign trade. Hence there is tremendous socio-economic development after nationalisation.

In spite of these, there are some strains and drawbacks in banking system which hinders the economic development of the country. Our Banking standards are very low compared to international standards. For example, the Capital Adequacy Ratio of Indian Banks is 9.5 per cent whereas Capital Adequacy Ratio of Banks in Hong Kong is 17.5 per cent , Singapore 18.7 per cent and Argentina is 18.5 per cent. Non-Performing Assets are very high in Indian Commercial Banks. Political and Administrative interference in credit decision making, delay in recovery of advances, infected portfolio in agricultural and small industrial credit , contamination of portfolio of priority sector lending and concessional lending ratio on priority sector credit lead to adverse affect on profitability of the banks. Besides, heavy increase in the expenditure, decrease in staff quality and lack of operational flexibility and poor customer service, alarms immediate the Government immediate action to reform the Banking sector. Hence, Government appoints a committee under the headship of Prof. M. Narasimham, the objective improving banking sector.

5.2 Narasimham Committee (1991):

After 1990’s the Financial sector witnessed financial sector reforms which were initiated with a view to promote a diversified, efficient and financial system in India. The specific goals of reforms are as under:

i) Correction and improvement macro economic setting in which banks operate, involving monetary policy reforms including rationalisation of interest rates, re-designing of directed credit programmes and reduction in levels of resource pre-exemptions.
ii) Improvement of the financial health and condition of banks by re-capitalising and restructuring of weaker banks etc.
iii) Building up existing financial institution, floating new financial institutions as well as support institutions and developing infrastructure relating to Supervision, Audit, Technology and Legal frame work.
iv) Improvement in the level of managerial competence and quality of human resources.
v) Improvement in access to financial savings.
vi) Promotion of competition through a level playing field and free entry /exit in financial sector.

5.3 Narasimham Committee recommendations:

The Narasimham Committee recommendations are based on the fundamental assumption that the resources of the banks come from the general public and held by the banks interests and that they have to be deployed for the maximum benefits of their owners, namely viz. the depositors. The assumption automatically implies that even the government has no business to endanger the solvency, health and efficiency of the nationalised banks and the pre text of resources for economic planning, social banking, poverty eradication etc. At the same time the government has no right to get hold funds of the banks at loan of interests and use them for financing its consumption expenditures – paying the salary of the employees.

The Narasimham Committee recommendations aimed at:

i) Ensuring a degree of operation flexibility.

ii) Internal autonomy for public sector banks in their decision making process.

iii) Greater degree of professionalism in banking operations.

The recommendations have been given into two phases. The first phase starts from 1992 to 1997. The second phase starts from 1997. The following are the recommendations given in first phase given on banking system.

1. Directed investments:

In this area the committee made two recommendations aimed at enhancing the competitive vitality of the banking industry.

a) **Statutory Liquidity Ratio (SLR):** According to the committee, the SLR should be brought down in paged manner from 38.5 per cent existing in 1991 to 25 per cent over a period of 5 years.

b) **Cash Reserve Ratio (CRR):** Every commercial bank in India has to keep with the RBI 15 per cent as minimum cash reserves against demand and time deposits. The committee proposed to RBI to considered progressively reducing the cash reserve ratio from its present high level. The committee also opined that interested pay to the bank and this SLR investment and Cash Reserve Ratio in respect of the impounded deposits on the basic minimum should be increased.

2.Directed credit:

As regards direct lending at present there is a direction to the banks by RBI that 40 per cent of net bank credit should go to priority sector which include agriculture, small scale industry, small business and programs per poverty alleviation. The committee recommended that the credit programmes should be phased out. The committee proposed the redefinition of priority sector to include only the smaller marginal farmers, the tiny sector of the industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections. The committee recommended the aggregate credit to the redefined priority sector to be fixed at 10 per cent.

3.Deregulation of Interest Rate:

The Narasimham Committee felt that the present structure of administered interest rates are highly complex and rigid and hence proposed to deregulate the interest rates so as to reflect margining market conditions.

4.Structure of the Banking System:

To bring about the greater efficiency in banking operations, the committee proposes substantial reduction in the number of priority sector banks to merges and acquisitions. According to the committee the broad pattern should consist of:

a) Three or four banks (including State Bank of India) which could be become international in character.

b) 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking.

c) Local banks whose operations would be generally confined to a specific region and

d) Rural banks including RRBs, whose operations would be confined to rural areas and whose business would be predominantly engaged in financing agriculture and allied activities.

Since the country has already network of rural and semi-urban branches, the present system of licensing branches with objective of spreading the bank habit should discontinued. According to the committee banks should have the freedom to open the branches purely on profitability considerations.

The committee wanted the government to make a positive declaration that there would be no more nationalisation of the banks. The committee further recommended that RBI should permit the setting up of new banks in private sector provided they confirm to the minimum start up capital and other requirements. There should be no difference between public sector banks and private sector banks.

The committee also recommended the government should allow foreign banks to open offices in India either as branches or as subsidiaries. They should confirmed to fulfil the same or similar social obligations as the Indian banks. Foreign banks and Indian banks should be permitted to set up joint ventures in regard to merchant and investment banking, leasing and other newer forms of financial services.

5.Prudential norms and Regulations:

Prudential norms and Regulations mean that norms and regulations relating to income recognition, provisioning for bad and doubtful debts and capital adequacy norms.

In regard to income recognition the committee recommended that in respect of bank and financial institutions which follow the accrual system of accounting, no income should be recognised in the accounts in respect of non-performing asset. An asset would be considered non-performing if interest on such asset remains past due for a period exceeding 180 days at the balance sheet date. The committee further recommended that banks and financial institutions be given a period of three years to move towards the above norms in a phased beginning with the current year.

For the purpose of provisioning the committee recommended that using a health code classification which is already vague in banks and financial institutions, the assets should be classified into 4 categories namely standard, sub-standard, doubtful and loss assets. In regard to substandard a general provision should be created equal to 10 per cent of total out standings under this category. In respect of doubtful debts provision should be created to the extent of 100 per cent of security short fall. In respective of secured portion of some doubtful debts, further provision should be created ranging from 20 per cent, 50 per cent depending on the period for which such assets remain in the doubtful category. Loss assets should either be fully return of or a provision be created to the extent of 100 per cent. The committee was of the view that a period of 4 years should be given to the banks and financial institutions to confirm to those provision requirements. However it is necessary for banks and financial institutions that in respect of doubtful debts 100 per cent of the security short fall is fully provided for the shortest possibly time.

The committee started that the balance sheet of banks and financial institutions should be transparent and full disclosures should be made in the balance sheet as recommended by the

International Accounting Standards Committee. This should be done in a phased manner commencing with the current year the committee suggested the criteria recommended for non-performing assets and provision requirements be given due recognition by tax authorities.

While coming to the capital adequacy of banking system the committee suggested the banks and financial institutions should achieve a minimum 4 per cent capital adequacy ratio in relation to risk weighted assets by March 1993 of which Tier I capital should not be less than 2 per cent. According to the bank of international settlements (BIS), standards of 8 per cent should be achieved over a period of three years that is March 96. For those banks, with an international presence it would be necessary to reach this figure even earlier.

The committee opined that in respect of those banks whose operations have been profitable and which enjoy a good reputation in the markets, they could straight away approach the capital market for enhancement of their capital. The committee therefore recommended that in respect of such banks, issue of fresh capital to the public through the capital market should be permitted. Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. In respect of other banks, the government could meet the short fall in respect of capital requirements by direct subscriptions to capital or by providing a loan, which could be subordinate debt.

Before arriving the capital adequacy ratio for each bank, it is given that the aspects of the bank are evaluated on the basis of their realisable values. The committee proposed that the banks and financial institutions adopt uniform account in practice particularly with regard to income recognition and provision against doubtful debts.

6.Recovery of Loans:

Banks at presents are experiencing considerable difficulties in recoveries of loan and enforcement of securities charge to them. The delays that characterise our legal system has resulted in the blocking of significant portion of funds and banks and DFIs in unproductive assets, the value of which determinates with passage of time. The committee therefore work out a suitable mechanism through which the due to the credit institutions could be realise with out delay and strongly recommended by Tiwari Committee on the subject be set up the process of recovery. The introduction of legislation for this purpose is long over due and should be proceeded immediately.

While the reform of accounting practices and the creation of special tribunals are essential, the committee stated that an arrangement has to be worked out under which at least part of the bad and doubtful debts of the banks and financial institutions are taken of the balance sheet. So that the banks could recycle the funds realise the process into more productive assets. For this purpose, the committee proposes the establishment of an Asset Reconstruction Fund (ARF). This could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, the level of discount being determined by independent auditors on the basis of clearly stipulated guidelines.

7.Computerisation of Banks:

The committee endorses the view of Rangarajan Committee that there is urgent need for a greater use of computerise systems that at present. Computerisation has to be recognised an indispensable tool for improvement customer service, the institution and operation of better control system, greater efficiency in Information Technology and betterment of the work environment for

employees. These are essential requirements for banks to function effectively and profitably in the increasing the complex and competitive environment, which is fast developing in the financial services segment of the economy.

8.Removal of Duality of Control:

The division of control by the ministry of finance should end immediately and the RBI should be the primary agency for the regulation of the banking system.

9.Free and Autonomous Banks:

Each bank should be free and autonomous. Each bank should go in for a radical change in work technology and culture, so as to become competitive internally and to be in step with wide ranging innovations taking place abroad. RBI should examine the various guidelines and directions issued by the government. The appointment of chief executive of a bank should not be based on political considerations but on professionalism and integrity and should be made by an independent panel of experts and not by government as at present.

Implementation of First phase of reforms:

First phase of reforms: RBI has implemented the following reforms so far

(1) Deregulation of entry of new private banks (domestic and foreign) in 1992-93.

(2) Liberalisation of branch licensing policy to allow more branches according to market needs condition to certain market requirements.

(3) Phase wise deregulation of interest rates on deposits and advances.

(4) Introduction of capital adequacy norm of 8 per cent.

(5) Institution of transparent prudential and income recognition norms.

(6) Allowing public sector banks to access the capital market to raise equity.

(7) Gradual reduction of CRR and SLR.

Liberalisation and deregulation (1) and (2) have been implemented to increase competition among banks. By 1996, 9 domestic and 11 foreign being had granted licenses after being convinced that the new entrants were well managed, financially and technically strong. Regarding (5), income recognition, classification and provisioning have been introduced. Regarding (6), the banks go to capital market for public issue to rise equity. Regarding (7) i.e., a phased reduction of CRR and SLR, the RBI has reached the levels recommended by NCFS to increase the profitability of the banks.

5.4 Impact of first phase of reforms:

The impact of first phase of reforms is discussed below.

(1) The number of private sector banks has increased marginally to create more competition.

(2) The non-interest of private banks has increased remarkably due to services like credit cards, merchant banking, lease etc.

(3) The non-performing assets of public sector banks increased about 17.5 per cent in 1996-97 and declined to 16 per cent in 1997-98. The private sector banks have 10 per cent NPAs. The ratio of net non-performing assets total to advances has declined from 9.2 per cent to 8.2 per cent.

(4) Almost all-public sector banks with the exception of few banks have achieved the capital adequacy of 8 per cent.

(5) The profitability of public sector banks has not much improved.

(6) The credit-deposit ratio declined during reformation period. It was 60.6 per cent in 1991-92 and declined 52.2 per cent in 1993-94.

(7) Bank credit expanded strongly in both in 1994-95 and 1995-96 after a sluggish growth in 1993-94.

(8) Operating profits and net profits of public sector banks have improved.

New Private sector banks:

As Narasimham Committee recommended that RBI should permit the setting up of new banks in private sector, provided they confirm to the minimum start up capital and other requirements many new private banks came in existence. The following are the new private sector banks:

1. IndusInd Bank Ltd.
2. The UTI bank Ltd.
3. HDFC bank Ltd.
4. The ICICI banking corporation Ltd.
5. Global Trust Bank Ltd.
6. Centurion Bank Ltd.
7. The Time Bank Ltd.
8. Bank of Punjab Ltd.
9. IDBI bank Ltd.
10. Development Credit Bank Ltd.

The following are the foreign banks opened or allowed to open their branches in India by RBI.

1. Barclays Bank.
2. Bank of Ceylon.
3. Bank Indonesia International.
4. State Commercial Bank of Mauraitius.
5. Development Bank of Singapore.
6. Chare Mahattar Bank.
7. Dresdner Bank.
8. Overseas Chinese Bank Corporation.
9. China Trust Commercial Bank.
10. Krung Thai Banking Public Committee Ltd.
11. Cho Hung Bank
12. Commerz Bank
13. Fiji Bank
14. Toronto Dominion Bank

The reforms under taken over the past few years were indeed epoch making and provided the foundation for on efficient and well functioning financial system there by facilitating the next stage of reforms i.e. second phase of reforms.

This a positive change in the banking sector after introduction of prudential norms. Same thing happened in case of sub-standard assets, doubtful assets and loss assets.

5.5 Second phase of reforms:

The second phase of reforms initiated with the implementation of some of the recommendations of Narasimham Committee II in 1998 on banking sector. The reforms provide further impetus towards building a strong, efficient and vibrant banking system in consonance with the internationally accepted standards and practices with greater transparency and credibility of the banking system.

5.6 Need for second phase of reforms:

Although substantial progress has already been made as a result of implementation of several recommendations made by the first Narasimham committee, it becomes necessary to go for further reforms in the banking sector. The second-generation reforms of Narasimham committee provided the basis for the further strengthening of the banking system for doing so in this direction. The following is the need for second phase of reforms.

1. At present the Govt. of India's equity share in nationalised banks is at least 51 per cent. With fierce competition, rigid adherence to such large ownership of capital by govt. of India with post-difficulties. Govt. capital in nationalised banks may be kept at nominal level as golden share as is found in some other countries.
2. Commercial banks in India are also required to maintain disclosure standards on par with those of international banks. This has been achieved by mandating disclosure of some of the essential strength indicators and performance related parameters as part of commercial banks balance sheet.
3. The debt-recovery tribunals which are working for commercial banks for effective recovery of loans from the public is not so efficient so that they should be strengthened for quicker recovery of bank loans.
4. Due to lack of capital base of many Indian banks, they are not in a position to take up big projects for financing. Therefore such banks should think for merging .The merger should be among sound banks only. However for the success of these mergers it is necessary that banks should be allowed to rationalise the branch network / staff strength.
5. Though the ratio of non-performing assets to net-assets has been reduced as per norms given in the first phase of reforms this reduction is not sufficient to compete with the international banking because the non-performing assets ratio is very low in USA i.e., 2 per cent and in Hongkong 1.5 per cent.
6. Most of the banks have reached capital adequacy ratio norm of 8 per cent by March 1997. But to compete outside India they have to improve capital adequacy ratio.
7. Many changes have been taken place in the field of banking technology but it needs to be emphasised that the process of technological changes is only beginning in India and several countries are way ahead of us in the modernisation of technology for their financial technology. Moreover the intensity of use of technology is more at lower levels.
8. The reserve requirements, particularly the cash reserve ratio presently around an average effective rate of a little over 9 per cent, is a severe drain on the profitability of banks. Further more the net non-performing assets of the banking system averaged about 10 per cent. These two factors taken together account for the major reason for the poor profitability of the Indian Banking system. If the CRR is reduced to 3 per cent of NDTL and the net NPAs are reduced to 3 per cent of advances the banks return on total assets which was less than 0.5 per cent, would raise to about 2.0 per cent.

5.7 Recommendations under second phase:

The following are the recommendations made under second phase:

1. Government securities marked to market 100 per cent with in next three years
2. Risk weight for Government securities 5 per cent
3. Risk weight for Government guaranteed advances same as other advances; immediately prospective accounts to be traded on par of other advances.
4. Foreign exchange opens position – at present 5 per cent risk weight, recommendation 100 per cent risk weight.
5. Capital adequacy ratio of 9 per cent by 2000, 10 per cent by 2002.
6. Government guaranteed advances which other wise would have been classified as NPAs should either be treated as NPAs or shown separately in the balance sheet as a move towards greater transparency in bank's operations.
7. Average level of net NPAs for all banks should be reduced to below 5 per cent by the year 2000 and 3 per cent by the year 2002. For banks with International presence the objective should be to reduce Net NPAs to 3 per cent by the year 2000 and nil percent by 2002.
8. Doubtful assets after 18 months and eventually after 12 months and loss asset if so identified and not written off.
9. Avoid "ever-greening" an account.
10. No relaxation in NPA classification.
11. Financial restructuring with the objective of having off the NPA portfolio from the books of the banks through securitisation or asset Reconstruction Company must go hand in hand with operational restructuring.
12. Freedom to banks in deciding lending rates and also beneficiaries under government sponsored schemes with in the priority sector advances.
13. To bring in alignment with the international practices, 90 days norm in regard to income recognition to be introduced in phased manner and general provision of 1 per cent for standard assets.
14. Adoption of international disclosure practices and consolidated balance sheet to be made mandatory to reveal the strength of the group.
15. Tax exemption for 20 per cent of rural advances as against 10 per cent at present.

5.8 Recommendations undertaken by the Government:

With the introduction of Narasimham Committee phase II recommendations banking sector has now ushered in the second generation of reform, the thrust of which is on improving the organisational effectiveness. The NC II gave emphasis on the following:

1. Reduction in govt. stake in banks to 33 per cent.
2. Stricter prudential norms.
3. Greater emphasis on asset liability management.
4. Introduction of narrow banking concept to rehabilitate weak banks.

5. Setting up of the Asset Reconstruction fund.
6. Integrate NFBCs with financial system.
7. Consolidation of the banking industry by merging strong banks.
8. Focus on the rationalisation of staff strength and branches.

5.9 Impact of Narasimham Committee Recommendations:

The commercial aspect again came to fore front with implementation of Narasimham Committee Recommendations, particularly the prudential norms for income recognition and asset clarification and provisioning. The income now could only be booked based on record of recovery as opposed to accrual method practised in the past. This removed the subjectivity, the discretion to auditors in classification of advances and brought in uniformity and transparency in the balance sheet of banks.

It is noticed that both in respect of geographical coverage and functional spread commercial banks have improved their position significantly. Average population served for office for commercial banks declined form 14 to 13 between 1992 and 1998. During the period per capita deposit and per capita advance improved significantly. They stood at Rs.2728 and Rs.1516 in 1992 and increase to Rs.6618 and Rs.3423 respectively in 1998. Credit deposit ratio on the other hand declined from 61.0 per cent in 1992 to 55.5 per cent in 1998. The short fall was however compensated by investment deposit ratio. Both credit deposit ratio and investment deposit ratio showed significant raises in the post reform period.

The following table gives the brief review of progress of commercial banks in post reform period.

Table No. 5.1

Progress of commercial banking in the post reform period

Year	Branches (in No.s)	Deposits (Rs. In crs)	Advances (Rs. In crs)	Credit-Deposit Ratio (in %)	Investment Deposit Ratio (in %)
1991	45326	231974	142900	61.6	N.A.
1992	45708	262875	104733	39.84	38
1993	46309	299504	113338	37.84	38
1994	47477	349388	114512	32.78	41.2
1995	47994	403404	203135	50.36	38.6
1996	48810	457639	252401	55.15	40
1997	49322	535025	274394	51.29	39.2
1998	50066	640514	322805	50.4	39.1
1999	50910	766815	366839	47.84	44.07
2000	51540	900307	443469	49.26	45.97
2005	101631	3242634	1914982	60.7	

Source:1. RBI, Banking Statistics (1972-95)
2. RBI, Selected banking indicators (1947-97)
3.RBI, Reserve Bank of India Bulletin, January 1999.
4. IBA Bulletin, March 2001

The following are the consequences of Narasimham Committee reforms:

5.9.1 Structural Reforms (Closing the branches):

As per memorandum of undertaking banks have agreed to effect branch closures for reducing the expenses of the branches. Of the identified 13,000 loss making branches were closed by March 1994. The government will not ask them to close, but direct them to convert these branches into satellite branches or ask them to merge with profit making branches but the branches in rural and semi-urban areas have been decreased after introduction of the reforms.

5.9.2 Prudential Norms and Regulations:

The initial reform measures centred on cleansing the balance sheet of banks, which was achieved by implementation of internationally followed prudential accounting norms. During 1992, the RBI introduced for the first time, detailed prudential norms and regulatory guidelines on income recognition, provision for Bad and Doubtful debts, classification of assets, and capital adequacy norms collectively known as prudential norms which have the highest pocket of financial discipline.

a) Income Recognition:

Under income recognition RBI gave guidelines to the banks as to when the banks can recognise interest as income and loan it to the profit and loss account and when they cannot. For the purpose of income recognition all the loan assets are classified into two categories.

(A) Performing assets (B) Non-performing assets.

A. Performing assets:

Any loan asset, which does not disclose any problems and in respect of which the bank is able to recover the interest and instalments as per the RBI guidelines, is a performing asset. Rather any asset, which is not an NPA, is a performing asset.

B. Non-performing Assets:

Generally, an asset becomes non-performing when it ceases to generate income for the bank. But keeping the Indian condition in view the RBI allowed the banks to treat an advance as performing asset even if interest is not recovered for a certain period quarter/ 3 quarter/ 2 quarters. The definition of NPA depends on the type of facility.

b) Asset Classification:

Under asset classification, banks are required to classify their loan assets into four categories namely standard, sub-standard, doubtful and loss assets. Other than standard assets, the rest are treated as non-performing (NPA) and no interest should be charged to or taken into account from these assets. Further, the income recognition from loan assets should be realised grater than on accrual basis. The classification will have to be done on the basis of degree of credit weaknesses and the dependence on collateral for purposes of realisation of dues.

(i)Standard Assets:

These assets do not disclose any problem and also do not carry more than normal risk attached to the business. These are not NPA.

(ii)Sub-standard Assets:

Such assets have been classified as NPA for a period not exceeding two years. The current net worth of the borrower/guarantee or the current market value of the security charged under such cases is not enough to ensure recovery of the dues to the bank in full. Such an asset will have well defined weaknesses that jeopardize that liquidation of the debt and perhaps the bank will have to sustain some loss if deficiencies are not corrected. Where instalments of term loans are overdue for a period exceeding one year should be treated as sub-standard asset. Where terms of loan agreement regarding interest and principal are renegotiated or rescheduled after commencement of production should be classified as sub-standard and should remain in such category at least for two years of satisfactory performance under the renegotiated or rescheduled terms.

(iii)Doubtful Assets:

An asset was treated as doubtful , if it remained as NPA for 12 months as against the earlier norm of 18 months. In term loans if the instalments of the principal have remained overdue for a period of exceeding two years should be treated as doubtful. A loan is classified as doubtful if all the weaknesses inherent in that classified as sub-standard with the added characteristics that weaknesses make collection or liquidation in full on the basis of currently known facts, conditions and values highly questionable and improbable.

(iv) Loss Assets:

Where the loss on an asset has been identified by bank or internal auditor or the RBI inspector but that amount has not been written off wholly or partly is known as loss asset. Such an asset is uncollectible and is of such little value that it is not desirable to show it as bank's asset though it may have some salvage or recovery value.

c) Provisioning:

Basing on the asset classification banks are required to make adequate provision on their assets ranging from 10 per cent (in case of sub-standard assets) and 100 per cent in case of loss assets. From financial year 1999-2000 onwards banks have been asked to make a general provision of 0.25 per cent in respect of standard assets. While initially the prudential norms were liberal, gradually the rigours of asset classification became more stringent.

The following are the provisioning of various assets:

(i)Standard Assets:

At present, the provision on standard assets is 0.25 per cent. After three months of non-payment of interest amount , the asset will become NPA.

(ii) Sub-Standard Assets:

Regarding the provision on sub-standard assets on secured assets , the provision is at 10 per cent and on unsecured assets, the provision is 20 per cent.

(iii) Doubtful Assets:

As per the earlier guidelines, banks were advised to make a provision of 50 per cent in respect of the secured portion of NPAs included in 'doubtful for more than three years' category irrespective of its age, till it is identified as a loss asset. On a review, it has been identified as a loss asset. On a review, it has been decided in June, 2004 to introduce a grade higher provisioning on

the secured portion of NPAs under this category as on March 31, 2004, ranging from 60 per cent to 100 per cent over a period of three years in a phased manner, with effect from March 31, 2005. However, in respect of all advances classified as 'doubtful for more than three years' on or after April 1, 2004, the provisioning requirement would be 100 per cent. The provisioning requirement for unsecured portion of NPAs under the above category will continue to be 100 per cent.

(iv) Loss Assets:

The provision on loss assets for both secured and unsecured is 100 per cent.

Table : 5.2

Classification of Loan Assets – Bank Group – wise

(As at end – March,2005)

(Percent%)

Bank Group/Year	Standard Assets	Sub-Standard Assets	Doubtful Assets	Loss Assets	Total NPAs
1	2	3	4	5	6
Scheduled Commercial Banks					
2002	89.6	3.1	6.1	1.2	10.4
2003	91.2	2.6	5.1	1.2	8.8
2004	92.8	2.3	4.0	0.8	7.2
2005	94.9	1.2	3.3	0.6	5.1
Public Sector Banks					
2002	88.9	3.1	6.6	1.4	11.1
2003	90.6	2.6	5.6	1.2	9.4
2004	92.2	2.6	4.3	0.9	7.8
2005	94.6	1.3	3.5	0.7	5.4
Old Private sector Banks					
2002	89.0	4.2	6.0	0.8	11.0
2003	91.1	2.9	5.4	0.6	8.9
2004	92.4	2.0	4.7	0.9	7.6
2005	94.0	1.1	4.1	0.8	6.0
New Private Banks					
2002	91.1	3.8	5.0	0.1	8.9
2003	92.4	2.9	3.9	0.9	7.6
2004	95.0	1.6	3.1	0.3	5.0
2005	96.2	1.1	2.4	0.3	3.8
Foreign Banks					
2002	94.5	1.7	2.0	1.8	5.5
2003	94.7	1.8	1.7	1.8	5.3
2004	95.2	1.6	1.8	1.5	4.8
2005	97.0	0.9	1.3	0.7	3.0

Note: Constituent items may not add up to the totals due to rounding off.
Source: DSB Returns (BSA) submitted by respective banks.
Source: Report on Trend and Progress of Banking in India 2004-05.

The above table shows that the standard assets of scheduled commercial banks have been increased from 89.6 per cent in 2002to 94.9 per cent in 2005. At the same time other assets like sub-standard, doubtful and loss assets have been decreased. This is due to the various measures

taken by scheduled commercial banks for recovery of loans like One Time Settlement (OTS)/ Compromise Scheme, Regular Monitoring of Loans, To control the slippery of loans from standard to sub-standard assets etc.

Table: 5.3

Distribution of Scheduled Commercial Banks by Ratio of Net NPAs to Net Advances

(Number of banks)

Bank Group	As at end march				
	2001	2002	2003	2004	2005
1	2	3	4	5	6
Public sector Banks	**27**	**27**	**27**	**27**	**28**
Up to 2per cent	1	-	4	11	19
Above 2 and up to 5 percent	5	9	14	13	7
Above 5 and up to 10 percent	16	15	7	3	2
Above 10 percent	5	3	3	-	-
Old Private Sector Banks	**23**	**22**	**21**	**20**	**20**
Up to 2per cent	1	2	2	2	4
Above 2 and up to 5 percent	4	2	4	9	12
Above 5 and up to 10 percent	11	13	13	7	4
Above 10 percent	7	5	2	2	-
New Private Sector Banks	**8**	**8**	**9**	**10**	**9**
Up to 2per cent	1	1	3	4	5
Above 2 and up to 5 percent	5	3	2	5	3
Above 5 and up to 10 percent	2	4	3	-	1
Above 10 percent	-	-	1	1	-
Foreign Banks	**42**	**40**	**36**	**33**	**31**
Up to 2per cent	21	21	20	21	23
Above 2 and up to 5 percent	6	4	2	3	2
Above 5 and up to 10 percent	4	1	6	3	2
Above 10 percent	11	14	8	6	4

Source: Report on Trend and Progress of Banking in India 2004-05.

It is clear from the above table that in public sector banks there is only one bank up to 2 per cent in 2001 , the number has been increased to 19 banks who had percentage of NPA's upto 2 per cent in 2005. This is really very good performance of public sector banks. But in other groups of banks like old private, new private sector banks, there is not much change. In foreign banks, the number has been decreased from 42 in 2001 to 31 in 2005. This shows that public sector banks has done very good effort to reduce.

NPA Management By Banks

One-Time Settlement/Compromise Scheme:

In May 2003, the time limit for processing of applications received under the revised guidelines for compromise settlement of chronic NPAs of public sector banks, up to Rs.10 crore was extended to December 31, 2003. Based on the requests received for further extending the time limit for operation of the guidelines and in consultation with Government of India, the time limit for receiving applications was further extended up to July 31, 2004.

Lok Adalats:

With the enactment of Legal Services Authority Act, 1987, Lok Adalats were conferred a judicial status and have since emerged as a convenient method for settlement of disputes between banks and small borrowers. The Reserve Bank has issued guidelines to commercial banks and FIs advising them to make increasing use of Lok Adalats. Government has recently revised the monetary ceiling of cases to be referred to Lok Adalats organised by Civil Courts from Rs.5 lakh to Rs.20 lakh.

The number of cases filed by commercial banks with Lok Adalats stood at 485,046 involving an amount of Rs.2,433 crore. The number of cases decided was 205,032 involving an amount of Rs.974 crore, and the recoveries effected in 159,316 cases stood at Rs.328 crore as on March 31, 2004.

Debt Recovery Tribunals (DRTs):

To recover the non-performing assets of value of more than Rs.10 lakhs, the bank can file a case in Debt Recovery Tribunals and these tribunals will solve the case of the bank, and help the bank to recover the money from the client. The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993 to provide for the establishment of tribunals for expeditious adjudication and recovery of debts due to banks and FIs and for matters connected therewith and incidental thereto. The amendments made in 2000 to the above Act and the Rules framed thereunder have strengthened the functioning of DRTs. On the recommendations of the Reserve Bank, Government has since set up a working group headed by Additional Secretary (FS), Government of India to improve the functioning of DRTs.

As on June 30, 2004, out of 63,600 cases (involving Rs.91,926 crores) filed with DRTs by the banks, 27,956 cases (involving Rs.25,358 crore) have been adjudicated by them. The amount recovered so far through the adjudicated cases is placed at Rs.7,845 crore.

Asset Reconstruction Companies (ARCs):

As per the announcement in the Union Budget 2000-03, Asset Reconstruction Companies (ARCs) has been established with the participating of public and private sector banks , financial institutions and multi-lateral agencies. Such a move helps to bank to tackle the NPAs and to provide them with an opportunity to take the NPAs out of their Balance Sheets. At the same time It is expected that the ARCs would be able to recover more bad loans because they would be exclusively dedicated towards loan recovery.

A bank could sell its non-performing asset to an ARC at commission on discount , which is charged to profit and loss account in return for bonds issued by the ARC, without loss of generality, to clean up their balance sheet. The ARC, which buys the asset, with bonds issued to the bank (or the public) can make a profit if it is able to reconstruct it or dispose it off at a higher price.

Progress under the SARFAESI Act:

The enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security interest (SARFAESI) Act has provided a significant impetus to banks to ensure sustained recovery. The Act provides, *inter alia,* for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. The Government of India has also notified the Security Interest (Enforcement) Rules, 2002 to enable secured creditors to authorise

their officials to enforce the securities and recover the dues from the borrowers. Banks and financial institutions (FIs) have already initiated the process of recovery under the Act. The Government has advised the PSBs and financial institutions to take action under the SARFAESI Act and report the compliance to the Reserve Bank. The Supreme Court has stayed the operation of the Act to a limited extent so that secured assets, can be seized under the Act, but cannot be sold/leased or assigned. Since the Act provides for sale of financial assets by banks/financial institutions to Securitisation Companies (SC)/ Reconstruction Companies (RC) created thereunder, a set of guidelines has been issued to banks and All-India financial institutions so that the process of asset reconstruction proceeds on smooth and sound lines in a uniform manner. These guidelines, *inter alia*, prescribe the financial assets which can be sold to SC/RC by banks/FIs , procedure for such sales (including valuation and pricing aspects), prudential norms for the sale transactions (viz., provisioning/ valuation norms, capital adequacy norms and exposure norms) and related disclosures required to be made in the Notes on Accounts to their balance sheets.

5.9.3 Capital Adequacy Norms:

The ownership of public sector banks by the government has acted as a pillar of confidence even though some banks reported losses after the implementation of prudential norms. However, as losses have to be eventually set against capital and reserves, prudence demands that banks have adequate cushioning to meet such contingencies. Moreover, in the deregulated environment, there is a vital need to link risk exposure with capital funds.

Until the acceptance of the Basle Accord, the term capital referred to the owned funds of a bank comprised or a paid up capital and disclosed free reserves. After accepting the Basle accord, in the process of strengthening the soundness and stability of banking system, the RBI decided that banks operating in India should also achieve the capital adequacy of 8 per cent in a phased manner as recommended by the Narasimham Committee. In terms of RBI guidelines, all banks functioning in India have to maintain capital in accordance with the following works.

Foreign Banks (in India)	8% by 31/3/94
Indian Banks (with branches abroad)	8% by 31/3/94
Banks operating in India only	4% by 31/3/93
	8% by 31/3/96
Extended later up to	31/3/97

The percentage has to be worked out on the risk-adjusted assets of the banks. All the assets including the contingent are given different weightages depending on the degree of risk involved. The assets are multiplied with appropriate weightages and the resultant total is known as risk adjusted assets. The percentage prescribed for capital adequacy is calculated on the risk-adjusted assets.

Further it was envisaged that at least half of the recognised capital must be in form 'core Tier-I capital which includes:

- Disclosed Reserves
- Common Stock
- Non-Cumulative Preference shares

The reminder (Tier 2) capital includes components such as:

- Undisclosed Reserves

- General Provisions
- Asset Revaluation Reserves
- Hybrid capital Instruments
- Subordinated Term Debt

This served mainly two purposes as under:

(a) 'Reflecting the promoters' stake in the enterprise and acting as a disincentive to them to take up higher risk investments and

(b) Serving as a buffer to absorb adverse effects on a Bank because of various risks.

At that time the cause for concern of Indian Banks was low capital base. Capital and reserves average was about 1.5 per cent of assets in India as compared to 4 per cent in Korea and Pakistan and 4 per cent to 6 per cent in Taiwan, Thailand and Singapore.

The 8 per cent norm cannot be operated like a 'one size fits all' formula. This reflects only the minimum and it is for each regulation authority to prescribe capital ratios for individual banks. The merit of the 8 per cent prescription is that it is superior to a regime where there were in such prescriptions and for countries introducing these norms, the objective has to be to attain this minimum, in the initial phase and then make the prescription bank specific. Capital is a cushion against losses. Just because banks are owned by government it does not mean that the intrinsic commercial element is to be ignored.

Capital Adequacy Norms includes capital restructuring , public issue of shares by the banks, issue of debt instrument in tier to capital and refund of capital by the banks to the Government.

Basel II:

The Basel Committee on Banking Supervision (BCBS) released the International Convergence of Capital Measurement and Capital Standards on June 26, 2004 which is expected to be implemented by the end of 2006. The main objective for revision in the 1988 Accord was to develop a framework that would further strengthen the soundness and stability of the international banking system by promoting adoption of stronger risk management practices by the banking industry. To foster greater financial stability, the Basel Committee blended several policy approaches to replace the existing capital framework. Basel II consists of three mutually reinforcing pillars.

The first pillar aligns the minimum capital requirements more closely to banks' actual underlying risks. Many banks will rely on external measures of those risks to determine their capital requirements. These might determine their capital requirements. These might include drawing on credit ratings issued by external rating agencies or on supervisors' assessments of the degree of operational risk inherent in various businesses. More sophisticated institutions, in comparison, may qualify to rely partly on their own measures of those risks when determining their capital requirements, an innovation that will help to create economic incentives for banks to improve those measures.

The second pillar- supervisory review – allows supervisors to evaluate each bank's assessments of its own risks and to determine whether those assessments seem reasonable. Ultimately each bank's own management is responsible for assessing and responding prudently to all of the risks that a bank faces, including those risks that might not be captured entirely in the first pillar. The second pillar will therefore foster a dialogue between banks and their supervisors on the nature of the risks that banks face and the measures they take to control them, including

holding aside sufficient levels of capital. That dialogue creates great implicit incentives for management to undertake careful evaluations of the bank's capital needs.

Finally, the third pillar, market discipline, recognises the power of market place participants to motivate prudent risk management. By enhancing transparency in bank's financial reporting, the third pillar provides counterparties, investors, and other participants with greater insight into a ban's risk profile; that increases their ability to distinguish and reward banks that are well managed, while penalising those that are not.

One might say that Basel II seeks an "efficient frontier" of policy objectives through the three pillars. Each pillar provides something that the other two cannot. Each is essential to achieving our overall objective of financial stability – an objective that would benefit all countries in all stages of development.

Of course, some of the advanced approaches offered in Basel II are intended for large and/ or sophisticated banking organisations; this has sometimes led bankers and supervisors in particular regions of the world to ask me whether Basel II is relevant to their situations. So I'd like to turn now to address some of the questions that I have heard frequently from bankers and supervisors especially in emerging market countries.

Basel I provides only the minimum requirements for the banks. It did not mentions about the risk management. But the Basel II want to create incentives for the industry to enhance the state of the art in risk management. Because improving management helps to increase the stability of the global financial system. It will benefit not only banks but more broadly businesses and consumers.

Table: 5.4
Capital Adequacy Ratio-Bank Group-wise

(As at end-March)
(Per cent)

Bank Group	2000	2001	2002	2003	2004	2005
1	2	3	4	5	6	7
Scheduled Commercial Banks	11.1	11.4	12.0	12.7	12.9	12.8
Public Sector Banks	10.7	11.2	11.8	12.6	13.2	12.9
Nationalised Banks	10.1	10.2	10.9	12.2	13.1	13.2
State Bank Group	11.6	12.3	13.3	13.4	13.4	12.4
Old Private Sector Banks	12.4	11.9	12.5	12.8	13.7	12.5
New Private Sector Banks	13.4	11.5	12.3	11.3	10.2	12.1
Foreign Banks	11.9	12.6	12.9	15.2	15.0	14.0

Source: Report on Trend and Progress of Banking in India, 2004-05.

The over CRAR of SCBs at 12.8 per cent at end-March 2005 was more or less at the previous year's level (12.9 per cent). The ratio continued to be significantly above the stipulated minimum even after satisfying the new requirements pertaining to the capital charge for market risk .

5.9.4 Directed Investments:

One of the major elements constricting the operational flexibility of banks and depressing banks' income earnings has been the system of directed investment in terms of minimum statutory liquidity ratios. This, together with the variable cash reserve ratios, today account for the pre-emption well over half of the total resources mobilised by the banking system. A major problem faced by the banking system was on account of constraints mainly in terms of massive pre-

emption of banks' resources to finance Government budgetary needs and administered interest rates. Removal of these constraints meant a plan reduction statutory pre-emption and a gradual de-regulation of interest rate prescriptions.

Statutory Liquidity Ratio:

Section 24 (2A) of Banking Regulation Act 1949 requires every banking company to maintain in India in cash, gold or unencumbered approved securities or in the form of net balances in current accounts maintained in India by banks with Nationalised Banks, equivalent to an amount which shall not at the close the business on any day be less than 25% of the total of its demand and time liabilities (to be computed as in case of CRR) in India, which is known as Statutory Liquidity Ratio.

Statutory Liquidity Ratio in the Post Reform Period:

Narasimham Committee recommended to reduce Statutory Liquidity Ratio to 25 per cent gradually. The following table shows the performance of Statutory Liquidity ratio during reform period.

Table: 5.5

Statutory Liquidity Ratio

Date	SLR
Apr-92	38.5
Jan. 9.1993	38.25
Feb. 6,1993	38
Mar 6,1993	37.75
Aug. 21.1993	37.5
Sep. 18,1993	37.25
Oct. 16,1993	37
Nov. 13,1993	36.75
Aug. 20,1994	34.25
Sep. 17,1994	33.75
Oct. 19,1994	37.5
Oct. 22,1997	25
July, 2002	25
July, 2003	25
July, 2004	25
July, 2005	25

Source: Reserve Bank of India Bulletins, various issues

The above table shows that on April the SLR was 38.5 per cent . It has been gradually decreased and by October, 1997 it came to 25 per cent and it continued in the same manner.

Cash Reserve Ratio:

CRR refers to the ratio of bank's balances with RBI to the ban's net demand and time liabilities. The objective of maintaining a minimum balance with RBI is basically to ensure the liquidity and solvency of the scheduled banks.

The system of maintaining a minimum cash balance with the Central Bank of a country had originated in USA. Federal Reserve System of USA utilised the method of minimum cash reserves for controlling the volume of credit in the economy. By varying the case reserves to be maintained the Federal Reserve System successfully used it as measure of credit control.

Table No: 5.6

Cash Reserve Ratios during 1993-99	
Date	**CRR**
April 17th 1993	14.50
June 11th, 1994	14.50
July 9, 1994	14.75
Aug. 6th, 1994	15.00
Nov. 11th, 1995	14.50
Dec. 9, 1995	14.00
Aug. 6th. 1994	15.00
Nov. 11,1995	14.50
Dec. 9,1995	14.00
April 27,1996	13.50
May 11th, 1996	13.00
July 6th, 1996	12.00
Oct. 26th, 1996	11.50
Nov. 9th, 1996	11.00
Jan. 4th, 1997	10.50
Jan. 18th, 1997	10.00
Oct. 25, 1997	9.75
Nov. 22nd. 1997	9.50
Dec. 20th, 1997	9.25
Jan. 17th, 1998	9.00
Feb. 28th, 1998	8.75
March 28th, 1998	8.00
Apr. 11th, 1998	10.00
Aug. 29,1998	11.00
Mar. 13,1999	10.50
May, 8th, 1999	10.00
Nov. 20th 1999	9.00
Apr. 8th, 2000	8.50
Apr. 22nd, 2000	8.00
July 29th, 2000	8.25
Aug. 12th, 2000	8.50

Source: RBI Bulletin various issues

The above table shows during the reform period, the CRR ratio has been decreased tremendously, because Narasimham Committee recommended to reduce CRR ratio 10 per cent. It is clear from the above table in April 93, CRR ratio was 14.5 per cent whereas in August, 2000 it has been decreased to 8.2 per cent. In July, 2005, the CRR ratio was 5 per cent.

Following the Narasimham Committee recommendations RBI has reduced SLR ratio to 25 per cent and CRR ratio to 10 per cent. It is important to find out what the impact of this reduction is on commercial banks. Because of reduction in these ratios, cash reserves in the banks will be increased. These reserves can be used for giving more advances or for buying more investments for the bank. It is important to observe how the bank advances have been increased after the implementation of these reforms. This shows that reduction of CRR ratio leaves more funds with the bank. That is why, there is a tremendous increase in advances and advances to priority sector by the banks.

5.9.5 Priority Sector Advances:

One of the recommendations of Narasimham Committee was a decrease in the priority sector advances of public sector banks from 40 per cent to 10 per cent. When the banks were nationalised during 1969 RBI prescribed that 40 per cent of bank advances should be given to priority sectors. Priority sector consists of agriculture, small-scale industries, self-employment, retail business, transportation and export business. But the Narasimham Committee, 1991 in its report mention that banks profitability is decreasing due to the priority sector advances. Among the priority sector advances there is a possibility of more non-performing assets. That is the committee recommended to reduce the priority sector advances from 40 per cent to 10 per cent. But the RBI never asked the banks to reduce the priority sector advances. But it did not pressure the banks about 40% priority sector advances. It is better to review the priority advances in public sector banks.

Table No: 5.7
Priority Sector Advances to Agriculture and Small Scale Industries
(Rs. In crores)

Year	Agriculture	Small Scale Industries	Others priority sectors	Total	%ag of priority sector advances to NBC
1991	15857 (37.51)	16783 (-39.7)	9636 (22.79)	42276 (100)	40.02
1993	20020 (41.22)	19388 (39.92)	9155 (18.85)	48563 (100)	36.64
1995	23513 (38.05)	25483 (41.24)	12798 (20.71)	61794 (100)	36.56
1997	31012 (39.19)	31542 (39.86)	16577 (20.95)	79131 (100)	41.72
1999	40078 (37.39)	42674 (39.81)	24448 (22.81)	107200 (100)	43.54
2001	53571 (14.3)	48400 (14.6)	40791 (9.7)	149116 (100)	43.7
2003	73507 (15.3)	52988 (11.1)	71448 (15)	203095 (100)	42.5
2005	112475 (15.7)	67634 (9.4)	129984 (18.1)	310093 (100)	43.2

Source: IBA Bulletin November 2001.

Report on Trend and Progress of Banking in India, 2002-03, 2004-05. RBI Publications.
Figures in the brackets denotes percentage of the total.

This table shows the priority sector advances given by public sector banks during financial sector reform period. The priority sector advances increased from Rs. 42276 crores during 1991 to Rs. 310093 during 2005.This shows that the priority sector advances are continuously increasing along with the net bank credit. After the reforms had been introduced the priority sector advances had been decreased. During 1991 the percentage of priority sector advances to net bank credit was 40.02 , but in 1993 and 1995 they have been reduced to 36.64 per cent and 36.51 per cent respectively. This shows that immediately after the reforms RBI is not strict about the priority sector advances. Because of many banks went to red due to provisioning . From 1997 onwards these banks were able to recover themselves and try to reach the norm of 40 per cent. Hence, during the years 1999, 2001 and 2005 the percentages of priority sector advances had been increased to 43.54, 43.7 and 43.2 per cent respectively.

5.9.6 Computerisation of Banks:

Importance of Computerisation:

The financial sector reforms since 1991-92 in the country have facilitated the dawn of LPG (Liberalisation, Privatisation and Globalisation) in the horizon of Indian Banking industry. In the emerging scenario, the LPG strategy has light sea changes that pace both opportunities as well as threats to the public sector banks, which are mentioned below.

- More competition
- Innovation of various financial products
- High customer expectations for quality and valued service
- Marketing of banking products/ services.
- Asset liability mismatch
- Increase in business risks
- NPA Menace
- Capital restructuring
- E – Commerce and Internet banking
- Wholesale and retail banking
- Tele-Banking
- Home banking
- Any where and any time banking
- Universal banking and narrow banking

Information technology used in banking can be termed as banking technology. The historic agreement of 1993 with the staff unions has opened up new vistas of Computerisation in every functional area of banking. It has come to stay in the banking industry. The recent direction of the Central Vigilance Commission to banks to computerise at least 70 per cent of branches by January 1, 2000, and making it non-negotiable with the unions have cleared the road for bank management to drive their banking on wheels of Information Technology to the 21st century. Banking Technology is going to decide that not only efficiency of other banks but also the survival, depending on how the banks manage the technology.

Brief Review of Information Technology Impact in the banking Industry:

The Indian Banking Industry is no longer an isolated entity. It is needless to state that Information Technology is the key enabler for the banking Industry to stay ahead in the next Millennium. Infotech is to enhance profitability and exploit new growth opportunities.

1. Automated Teller Machines: ATMs are born as a result of customer's need for quick and convenient service and access to money round the clock and also through out the year. Through the shared ATMs network concept the customer of any bank can use ATMs of any banks.

2. Tele Banking: It is mainly used to get information about the bank, its products, balance enquiry, cheque book request and so on. By 2001, it has become the accepted norm of banking.

3. Anywhere Banking: It enables select customers to collect and realise money at cities other than where they have their accounts and to make payments at other centres.

4. On-Line Debit Technology: The bank handles debit transactions with the help of customised terminal software to support it. A secure Personal Identification Number (PIN) is provided through PINPAD for data entry. The PINPAD is a security device to a cardholder to enter his pin in privacy. 'Encryption' protects the PIN as it flows through the system by making it electronically unrecognisable, a modern day version of scrambling.

***5.* Integrated Treasury Management Software-Multi Currency Accounting System Software:** It facilitates integration of the rupee and foreign exchange transactions. As of today where two separate departments in the banks are required to look to rupee and foreign exchange, under ITMS a single senior executive can handle the task.

***6.* Banking On Touch:** Spain's Bank la Caixa is using tough touch Micro Systems Inc's touch screen solution. It serves faster and makes an easier access to ATMs for payments. This touch screen ATMs provides multi function services apart from standard cash withdrawals. It helps customers to access information easily and quickly on account balance, last debits or credits etc., that can be retrieved.

7.* Service Provide Network of Tomorrow*: System Provider Networks (SPNs) can be classified as generic and specific SPNs. A Generic SPN (GSPN) provides methods and mechanisms which are independent of the application or activity and are common across a vast domain of applications. Stock market is an example of a specific SPN or GSPN.

8.* Electronic Clearing Services*: The Electronic Clearing Services (ECSs) benefit bank customers and investors in shares, debentures and deposits.

***9.* Directed Credit:** It is related with the dividend, interest, commission, salary, pension, Income tax refund and any other such other regular income where in the amount is directly credited in the bank account.

10. Directed Debit: It deals with the payment of telephone bills, electricity bills, loan instalments, insurance premium, fees of school and college, clubs and credit card dues, water taxes, property taxes and any such other regular payments where in these are directly debited from the bank account. The resultant benefits of ECS are as follows.

1. It eliminates postal loss and delay as well as paper work and lengthy procedures.
2. It saves cost on stationery, printing and postage.
3. It ensures that no fraudulent encashment takes place.
4. It facilitates immediate receipt and payment of dues.
5. It leads to Automatic Reconciliation.
6. It turns appreciation from investors and customers.

Net Banking:

The Internet banking will become a primary channel for the distribution of banking services in the next few years. It is interesting to study how various banks in India have developed the concept of net banking. Net Banking includes On-line Internet Banking. When a customer makes a transaction it affects his balance. He doesn't have to wait for it to be updated, it is instantly reflected in his account balance. He can even view it in his statements.

The key benefits that the customer can avail of net banking are as follows.

Electronic Funds Transfer:

It helps the customers to transfer funds between any of their accounts in any of their branches easily.

New Fixed Deposit Request:

It facilitates to open a FD account on the net. The customers are only required to provide details on the transfer of funds from their specific account, account number, amount and tenor and its relevant maturity terms. The customers can also specify mode of receipt of interest on maturity date as the case may be.

Banker's Cheque Request and Demand Draft Facility:

One can get a banker's cheque or a demand draft issued from his/her account by providing details on account to be debited, amount, location and beneficiary. The bank also provides courier facility for onward transmission of the banker's cheque and /or Demand Draft at the mailing address specified by customer.

The important constraint that the bank can issue Demand Draft provided that it has the branch or an arrangement with a correspondent bank. The processing of banker's cheque and/or Demand Draft takes place in the next working day after a customer sends in the requisition/instruction.

Tax deducted at source inquiry:

It helps customers by providing information on the tax deducted at source on any of the concerned bank's branches for the current and/or previous financial year.

Stop Payment Facility:

One can request stop payment on a cheque or series of cheques on line. To do so one needs to enter the cheque number and the reason for stopping payment.

Cheque status inquiry:

One can use net banking to find out the status of a specific cheque that has been issued from any of the accounts.

Cheque Book Request:

One can request for a new chequebook online. It will be couriered to the address as per the records in the bank.

Account Balance Inquiry:

One can easily find out the amount of balance held in any accounts namely savings, and/or current account including details on available funds, uncleared funds, ledger balance, over raft limit, hold funds and sweep in account in net banking.

Account Statement Inquiry:

In this a customer can view all the transactions that he/she has completed on his/her account for either the current period or a specific period as the case may be, and customers can also collect statement via mail as per the records in the bank.

Fixed Deposit Inquiry:

It is to access the details about his/her fixed deposit account namely principal balance, terms of deposit, rate of interest, maturity date, maturity amount, instructions for payment on maturity and lien amount.

5.9.7 Merges and Acquisitions:

Since nationalisation in 1969, banks and financial systems in India has made commendable progress in geographical spread and functional reach but at the same time due to deterioration in quality of loan portfolio, poor competition, unremunerative branch expansion, over manning, political interference in credit decision and internal management, trade union pressure and management weakness etc. financial health of the System was deteriorated which was reflected by decline in productivity and efficiency, erosion of profitability and poor customer service, hence a need for improving operational efficiency and reappraisal of the structural inadequacies of the banking system was felt.

Besides the second banking commission, various other committees like Sarraiya Committee, N.Vagul Committee, James Raj Committee etc. and forums have also looked into the issue of restructuring of banking system time to time and recognising the need for restructuring they all had suggested various alternative for restructuring they all had suggested various alternative for restructuring of banking system through mergers and amalgamations.

Table: 5.8

Recent Banks Mergers/Amalgamation in India-1985 Onwards

Banks	Merged/Amalgamated With	Year
Lakshmi Commercial Bank Ltd.	Canara Bank	1985
Bank of Cochin Ltd.	State Bank of India	1985
The Miraj State Bank of Ltd.	Union Bank of India	1985
The Hindustan Commercial Bank Ltd.	Punjab National Bank	1986
Traders' Bank Ltd.	Bank of Baroda	1986
United Industrial Bank Ltd.	Allahabad Bank	1989-1990
Bank of Tamilnadu	Indian Overseas Bank	1989-1990

The Bank of Thanjavur	Indian Bank	1989-1990
Parur Central Bank Ltd.	Bank of India	1989-1990
Purbanchal	Central Bank of India	1990-1991
New Bank of India	Punjab National Bank	1993-1994
Bank of Karad Ltd.	Bank of India	1993-1994
Kashinath Seth Bank	State Bank of India	1995-1996
Bari Daob Bank Ltd.	The Oriental Bank of Commerce	1997
Punjab Co-operative Bank Limited	The Oriental Bank of Commerce	1997
Bareilly Corp. Bank	Bank of Baroda	1998-1999
Beneras State Bank Ltd.	Bank of Baroda	2002
Nedungadi Bank	Punjab National Bank	2003
Global Trust Bank	The Oriental Bank of Commerce	2004

5.9.8 Deregulation of Interest Rates:

The important phase of the reform process has been the de-regulation of interest rates. The objective behind this deregulation by the RBI is to create competitive environment among the banks. Major reform measures, which have far reaching impact on the banking system, were entry of new banks, prudential guidelines and transparency of the balance sheets. While opening the system for competition, it was decided to provide greater autonomy for the banks by allowing them to fix interest rates on major portion of deposits and advances on their own. This has been done through deregulation of interest rates. The freedom given to banks to fix Prime Lending Rate (PLR) and term deposits rates under certain specific segment deposits on their own has led to what is popularly known as rate war among banks.

5.10 Profitability after Reforms:

After the study of implementation of reforms, it is necessary to find out the profitability after reforms. The following table shows a comparative study of Credit Deposit Ratio of various bank groups:

Table: 5.9
Growth in Net Profit –A Comparative study of various Bank Groups
During 1991-92 to 2004-05

(in crores)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	245	356	1670	2677	3449.48	5675.86
Nationalised	600	-4705	1445	2437	4851.76	9494.04
PSBs	845	-4349	3115	5114	8301.24	15784.4
Old Private	81	130	405	655	1004.48	435.81
New Private	—-	—	268	569	706.78	3097.56
Foreign Banks	387	504	652	967	815.68	2002.39
SCBs	1313	-3715	4441	7306	15679.94	36490.06

During the reform period, the net profit has been reduced very much. If we observe the public sector banks, the net profit in the pre-reform period was Rs. 845 crores, it has been reduced to loss of Rs.4349 crores in 1993-94 because due to introduction of the provision many banks

went into red. But later, they recovered themselves and yet present during 2004-05 the net profit of Public Sector Banks was Rs.15784.4 crores.

Table: 5.10
Growth of Spread- A Comparative Study of Various Bank Groups During 1991-92 to 2004-05
(in crores)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	4384	3782	7104	9290	12190.11	19203.27
Nationalised	5269	5174	10469	14795	19381.25	32199.16
PSBs	9653	8956	17573	24085	31571.37	51590.28
Old Private	568	686	1292	1813	2230.38	3621.48
New Private	—	—	426	1103	2010.18	6320.02
Foreign Banks	967	1403	2295	3190	3645.85	5130.94
SCBs	11188	11045	21586	30191	58839.03	118065.15

The spread is the difference between interest received and interest paid. Before reforms period that is in 1991-92, the spread of SCBs Rs.11188 crores. After the introduction of reforms , the spread has increased at present during 2004-05, the spread of SCBs is Rs.118065.15 crores.

Table: 5.11
Credit-Deposit Ratio-A Comparative of various bank groups during 1991-92 to 2004-05
(in per cent)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	71.06	53.8	56.06	50.35	46.88	59.42
Nationalised	56.45	45.77	45.57	46.38	51.17	57.32
PSBs	61.19	48.4	49.02	47.76	49.62	59.52
Old Private	52.45	48.83	55.1	50.14	52.56	58.37
New Private	—-	—-	59.85	47.26	83.32	77.9
Foreign Banks	54.42	44.33	72.64	72.21	75.39	87.1
SCBs	39.84	32.78	51.29	49.26	52.84	60.7

The table shows Credit Deposit Ratio of various bank groups. During 1991-92 , the ratio is very high, but after the reforms , the ratio has been reduced and slowly it has been increased. During 1993-94, the ratio of Scheduled Commercial Banks was 32.78 per cent, but later on 2004-05, the ratio has been increased to 60.7 per cent.

Table: 5.12
Business Per Employee- A Comparative study of various Bank Groups During 1991-92 to 2004-05

(in Lakhs)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	43.02	49.61	72.51	122.11	181.54	284.03
Nationalised	43.81	50.96	76.87	126.04	197.59	307.62
PSBs	43.54	50.49	75.31	124.62	191.57	297.85
Old Private	50.1	55.26	102.24	169.53	223.58	322.92
New Private	—	—	796.28	978.85	896.26	665.18
Foreign Banks	196.21	286.38	446.24	626.09	818.28	940.28
SCBs	39.6	48.37	84.08	140.84	211.39	321.43

The above table shows that Business per Employee has been tremendously increased from Rs.39.6 lakhs during 1991-92 to Rs.321.43 lakhs in 2004-05.

Table: 5.13
Non-Interest Income as percentage to Total Income- A Comparative study of various Bank Groups during 1991-92 to 2004-05

(in per cent)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	12.3	14.44	14.41	14.19	17.09	17.69
Nationalised	9.72	12.13	10.55	11.62	14.5	15.88
PSBs	10.74	12.98	12.01	12.59	14.1	6.99
Old Private	9.62	12.81	12.22	14.95	20.29	12.23
New Private	—-	—-	17.28	18.09	20.75	23.12
Foreign Banks	22.74	18.22	18.54	20.84	25.16	29.65
SCBs	11.82	13.46	12.8	13.76	16.22	17.98

The above table shows non-interest income as percentage to total income has been increased from 11.82 per cent in 1991-92 to 17.98 per cent in 2004-05. Because after reforms, the banks try to improve non-interest income through commission brokerage etc.

Table: 5.14
Net Profit as a percentage of Working Fund - A Comparative study of various Bank Groups during 1991-92 to 2004-05

(in per cent)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	0.21	0.25	0.82	0.8	0.77	0.91
Nationalised	0.33	-1.98	0.41	0.44	0.69	0.89
PSBs	0.28	-1.15	0.56	0.57	0.72	0.87
Old Private	0.57	0.57	0.92	0.84	1.08	0.22
New Private	—-	—-	1.66	1	0.41	1.13
Foreign Banks	1.57	1.51	1.17	1.17	0.73	1.28
SCBs	0.39	-0.85	0.66	0.66	0.00	0.9

The above table shows net profit as a percentage of Working Fund is .39 per cent in 1991-92 but it has been reduced immediately after reforms that is 1993-94 the percentage is (-.85) this is because of high provisioning , many banks went to red. But later , they recovered and again the percentage has been increased . During 2004-05, the percentage of SCBs is 0.9.

Table: 5.15
Spread to Working Fund- A Comparative study of various Bank Groups During 1991-92 to 2004-05

(in per cent)

Bank groups	91-92	93-94	96-97	99-00	2001-02	2004-05
SBI group	3.8	2.68	3.48	2.76	2.71	3.06
Nationalised	2.86	2.17	2.97	2.67	2.74	3.02
PSBs	3.22	2.36	3.16	2.7	2.73	2.91
Old Private	4.01	3.01	2.93	2.33	2.39	2.66
New Private	—	—	2.64	1.94	1.15	2.18
Foreign Banks	3.92	4.21	4.11	3.85	3.25	3.29
SCBs	3.31	2.54	3.21	2.72	2.51	2.91

What do you Spread is the different between interest received and interest paid. Before reforms, spread to working fund is very high . Immediately after reforms this has been reduced and at present it came to normal stage.

5.11 Summary:

In this chapter the objectives of financial reforms and the need for Narasimham Committee are given.. This chapter mainly deals with the Banking Sector Reforms with particular reference to Narasimham Committee Recommendations. The Narasimham Committee gave the recommendations on structural reforms, Prudential Norms, Directed Investments, Deregulation of Interest Rates, Computerization of Banks and Advances to Priority Sector Advances. The impact of first phase of reforms and the need for second phase of reforms is also explained. At the end the profitability after reforms was explained in detail.

5.12 Key Words

1. SLR - Statutory Liquidity Ratio
2. DRIs - Debt Recovery Tribunals
3. ECS - Electronic Clearing Services
4. SPNs - System Provider Networks
5. HB - Home Banking

5.13 Self Assessment Questions:

Short Questions :

1. What are the objectives of ‘financial Sector Reforms?
2. What is the need for second phase of reforms?
3. Give the provisions under the second phase of reforms.
4. What is Deregulation of Interest Rates?
5. What are the contents in the Prudential Norms?

6. What is Non-performimg asset?
7. What is Capital Adequacy Ratio?
8.What are Directed Investments?
9. What is Statutory Liquidity Ratio?
10. What is Cash Reserve Ratio?
11. What is the function of ATM?

Essay Questions :

1. Explain the recommendations of Narasimham Committee (1991).
2. What do you mean by Banking Sector Reforms ? State the importance of reforms in the recent years?
3. Evaluate the impact of banking sector reforms on the performance of commercial banks.
4. State the recommendations of Narasimham Committee on Banking Sector Reforms. How far are they implemented.
5.Explain the impact of technology on banking industry.

5.14 Suggested Readings

1. Guruswamy.S, Banking in the millennium, Kanishka Publishers
2. Monga G.S. and Sinha R.K.: Nationalisation of Banks Retrospect and Prospects
3. Amalesh Banerjee and Singh S.K. : Banking and Financial Sector Reforms in India
4. Gurley J.G. and Shaw, E.S. (1955) Financial Aspects of Economic Development, American Economic Review

Dr. Uttama Durga Devi

LESSON - 6

COMMERCIAL BANKS - INDUSTRIAL FINANCE

6.0 Objectives:

In this chapter, the author explains, the role of banks in Industrial Finance and the progress made by banks in providing credit to industry. It is felt the students will get a clear idea about Commercial Banks and Industrial Finance.

Structure:

6.1 Introduction

6.2 Banks - Industrial Credit

6.3 Banks - Small Scale Industries

6.4 Schemes of Assistance to Small Scale Industries

6.5 Progress made by Banks in Providing Industrial Credit

6.6 Special Schemes to assist Industry

6.7 Conclusion

6.8 Technical Terms

6.9 Reference Books

6.1 Introduction:

With the inauguration of planned development programmes, a major transformation, took place in the country's economic structure. The country embarked on a period of industrilisation with the beginning of second five year plan. In keeping with the growing tempo of industries action, the banking system was called upon to face new challenges and shoulder new responsibilities. Banks started providing a good amount of finance to Industries. The share of Bank credit reached its peak at 67.5% in March 1968. Industries like engineering, Iron and steel and chemical accounted for the bulk of the increase in the bank credit to the Industrial sector. After the evolution of the concept of priority sector, banks were asked to allot 40% of the total credit to the priority sector. So the share of Industry in total bank credit was reduced. But still the credit to industries accounted for nearly 40%. Banks are providing term loans, consortium lending and in some cases some portion of capital also. In recent days, in addition to direct credit to industries, banks are offering various schemes to assist industry, like Mutual Funds, Merchant Banking and Venture Capital etc. Despite the fact that there are Development Banks, specially meant for meeting the requirements of industries, the role of commercial banks is worth mentioning.

6.2 Banks - Industrial Credit:

Commercial banks provide short-term and medium term loans to Industries under term lending and consortium arrangements.

i. Term lending:

Term lending is based on the 'Anticipated income theory' of commercial bank assets. Neither the traditional concept of liquidity nor the criterion of shiftability can be applied to term loans. Generally these loans are given for long periods ranging from one to ten years. The loan is repaid over a period of years, out of the income of the industrial unit is concerned. Therefore the liquidity of there loans depends upon the anticipated income of the borrowing concerns. under term loans the borrowers secure funds at a specified rate of interest for a specified period of time. Under term lending commercial banks extend short-term and medium term loans to industries.

ii. Consortium/Participation arrangements:

Participation lending is an idea which should receive the increasing attention of our banks. This is all the more important in view of the unusually large requirements for working capital and expansion of certain individual big projects which are likely to grow, as the economy develops. Such participation in lending will enable a bank to limit the commitment in respect of any one party. In January 1979, the R.B.I. has made it mandatory for commercial banks to resort to consortium finance where the working capital needs of a borrower are Rs.5 Crore and above. The members of a consortium are expected to be minimum in number unless the funds involved are expectionally large. It is also stipulated that the share of each member bank, should not be less than ten percent of the aggregate working capital.

iii. Participation Certificates:

An interesting development in commercial banking during 1971 was the introduction of a scheme of participation certificates by some banks. A participation certificate is an instrument whereby a bank can sell to a third party a part or all of a loan made by the bank to a client. The objective behind the introduction of participation certificates is to provide for greater mobilisation of deposits, reduce recourse to the reserve bank and diversity the availability of financial instruments. It offers a short-term investment avert at a attractive rate of interest to the financial institutions and is useful adjunct to the New Bill Market Scheme. Since the participation certificates are issued only to the financial institutions, the funds that become available to the banks through the insurance of such certificates represent inter-institutional transactions. Some Indian banks and Foreign banks functioning in India have issued participation certificates to financial institutions like banks, LIC, Unit trust of India, General Corporation of India and similar other financial institutions incorporated in India. For the present, the scheme approved so far pertains only to working capital requirements.

6.3 Banks - Small Scale Industries:

The commercial banks including the R.R.Bs have played a pioneering role in providing developmental finance to small scale industries. After the nationalisation of major banks in 1969, the banks in India endeavoured to completely identify themselves with policies of the government in the matter of promotion of there small scale industries. Their developmental role has been evolving and getting enlarged over the years, in close consultation with the concerned promotional authorities. The banks provide individual unit-oriented services, as against infrastructured and generalised services provided by other government agencies. In recent years, banks have introduced innovative schemes with the support of the government and other financial institutions to foster the rapid growth of SSIs in India.

Within the broad framework, the following financial assistance as offered by the State

Financial Corporations, Small Industries Development Corporation and Commercial Banks.

1. Financing new projects in the small and medium category.
2. Financing of moderisation of the these industries.
3. Financing of rehabilitation of these industries.
4. Financing of import of capital equipment.

In view of the financial constraints being faced by Financial institutions and banks, Industrial Development Bank of India (IDBI) extends refinancing assistance, to the extent of 60% for the loans given by commercial banks to small scale and medium size units.

Financial Assistance to Small Scale Units:

Financial loans to small scale units are granted at a concessional rate of interest. The interest charged to there units in backward areas is at the rate of 12.5% P.A. In respect of units located in non-backward areas, the interest is charged at 13.5% P.A. on loans upto Rs.25 lakh and at the rate of 14% on loans in excess of Rs.25 lakh.

Financial Assistance to Medium Scale Units:

The Medium scale units are also eligible for concessional interest of 12.5% P.A. for units located in any industrially backward area. However, in respect of units located in non-backward areas, the applicable rate of interest shall be 14% P.A.

Modernisation Assistance to Small and Medium Scale Units:

The primary objective of this scheme is to encourage industrial units overcome the backlog of moderisation and to adopt improved and latest technology and methods of production and prevent mechanical and technological obsolescence. Units to be eligible for modernisation assistance should have been operational for atleast 5 years. The modernisation programmes should primarily aim at

1. Upgradation of Process, Technology and Product.
2. Export orientation
3. Import substitution
4. Energy saving and financial feasibility
5. Anti pollution measure.
6. Conservation/substitution of scarce raw materials and other inputs.
7. Improvement of capacity utilisation.
8. Improvement in material handling.

Irrespective of the location of the unit, interest at the rate of 11.5% P.A. shall be charged on all loans for their modernisation.

Rehabilitation Assistance to Small and Medium Scale Units:

The sick industrial undertakings cell in the Reserve Bank of India monitors the performance of commercial banks in corrective measures in regard to rehabilitation of sick units. The rehabilitation assistance is provided to small and medium scale units including ancillary units and units in cottage and village industries assisted by state finance corporations and small industries development corporations. IDBI provides refinance facilities for this assistance. Rehabilitation assistance would be for the following purposes.

1. Margin money for additional term loan and working capital requirements under the rehabilitation programme.

2. Working capital term loans, if any granted by banks to meet irregularities in the unit's working capital account.
3. Payment of statutory liabilities.
4. Cash loss if any incurred during the implementation of the programme.
5. Overdue installments not recovered from the unit but agreed to be funded into a separate term loan account, and minimum capital expenditure required for restarting the unit on a viable level.

6.4 Schemes of Assistance to small scale industries:

Financial institutions grant assistance to small scale industrial units for (1) Participation in equity capital, (2) Acquisition of fixed assets by way of term loans and (3) working capital. Usually banks and other financial institutions provide assistance to Industry under various schemes. The schemes can be explained as under.

1. Technical Scheme:

Under this scheme, Assistance would be provided to technically qualified or experienced professionals upto 7.50 lakh.

2. Special Capital Scheme:

Under this scheme, soft loan assistance upto Rs.4 Lakh is available on soft terms along with term loan for technically qualified or experienced persons.

3. Seed Capital Scheme:

Assistance would be provided towards equity on soft terms upto Rs.15 lakh along with term loan for technically qualified or experienced persons.

4. Composite Loan Scheme:

Both equipment finance and working capital upto Rs.50,000 for artisans and rural industries would be provided under this scheme.

5. Disabled entreprenuers:

This scheme provides 100% finance upto Rs.50,000 to disabled entreprenuers.

6. Modernisation:

Assistance would be provided for replacement renovation of equipment for successful units which are in existence since 5 years upto 90 lakh.

7. Electro Medical Equipment/Nursing Home, Hospitals:

Assistance for qualified Doctors, private Nursing Homes upto Rs.90 lakh and Assistance for full fledged Nursing Homes and Hospitals upto Rs.90 lakh, would be provided under this scheme.

8. Equipment Finance:

Assistance would be provided for existing industrial units for procurement of new machinery equipment upto Rs.90 lakh.

9. Quality Control Equipment:

100% assistance for setting up quality control facility by existing and new small scale units upto Rs.7.50 lakh, would be provided under this scheme.

10. Single Window Scheme:

Both term loan and working capital together to new tiny and small scale industrial units upto Rs.7.50 lakh towards term loan and Rs.3.75 lakh towards working capital.

11. Tourism related facilities:

Upto Rs.90 lakhs available for tourism related business ventions.

12. Mahila Udyam Nidhi Scheme:

This scheme is for women entreprenuers to set up new industrial projects in small scale sector by women entreprenuers.

13. National Equity Fund Scheme:

Assistance towards equity for new projects in tiny and small scale sector upto Rs.75,000, would be provided under this scheme.

14. Assistance for Marketing:

a) Maximum assistance upto Rs.3 lakhs per sales van, not exceeding six vehicles per borrower. (b) Assistance upto Rs.7.50 lakhs for setting up new sales outlets.

6.5 Progress made by Banks in providing Industrial Credit:

Banks made good progress in deploying credit to industry. This will be shown in the following table.

Table

Gross Bank Credit to Industry

Year	Gross Bank Amount of Credit (Rs. in crores)
1986	26,498
1987	31,005
1988	31,168
1994	80,482
1996	1,24,937
1998	1,61,038
2000	1,47,319
2001	1,62,837
2002	1,72,324
2003	2,10,335

Source: Banking Theory & Practice K.C. Sekhar

Report on trend and progress of Banking in India, R.B.I. 2001-02, 2002-03.

The above table reveals, how industrial credit is growing. Industrial credit as a percentage of net bank credit was 46.8% in 2001. It declined to 42.9% in 2002. Infrastructure, Textiles, food processing, and construction industries claimed a major portion of Industrial credit.

Banks are helping a lot in rehabilitating sick industries. The quantum of bank loans locked up in sick/weak industries increased marginally to Rs.26065 crore as at the end of March 2002.

6.6 Special Schemes to assist industry:

In recent years, Commercial Banks are understating various schemes to finance industry. Those can be explained as under.

Venture Capital:

The term venture capital denotes institutional investors that provide equity financing to new projects and play an active role in advising the managements. Venture capital is an important source of funds for technology based industries which contribute significantly to growth process.

Characteristics of Venture Capital:

The three primary characteristics of venture capital funds which make them eminently suitable as a source of risk finance are that:

(1) It is equity or quasi equity investment

(2) It is long-term investment.

(3) It is an active form of investment.

First venture capital is equity or quasi-equity because the investor assumes risk. There is no security for his investment. Venture capital funds, by participating in the equity capital institutionalise the process of risk taking which promotes successful domestic technology development.

Investors of venture capital have no liquidity for a period of time. Venture capitalists funds hope that the company they are backing will thrive and that after five to seven years from making the investment, it will become large and profitable enough to sell its shares in the stock market. There is a reward for illiquidity and waiting. The venture capitalists hope to sell their shares for many times more than what they paid for. If the unit pails the venture capitalist loses everything.

Secondly, venture capital is a long-term investment involving both money and time. Venture capital investment also involves participation in the management of the company. Venture capitalist participates in the Board and guides the firm on strategic and policy matters. The features of venture capital are generally

(1) Financing new and rapid growing companies

(2) Purchasing of equity shares

(3) Assisting in the transformation of innovative technology based ideas into products and services.

(4) Adding volume to the company by active participation.

(5) Assuming risk in the expectation of large rewards.

(6) Possessing a long-term perspective.

There features of venture capital render it eminently suitable as a source of risk capital for domestically developed technologies. New venture proposals in high technology areas are attractive because of the perceived possibility of substantial growth and capital gains.

Venture Capital Funds in India:

To finance venture proposals, the Government of India created a venture capital fund to be administered by IDBI. The budget for 86-87 imposed a levy on research and development payments made for import technology. The levy formed the source for funding venture capital fund.

In 1988, a scheme was formulated under which venture capital funds were allowed to invest in new companies and be eligible for the concessional treatment of capital gains available to non-corporate entities.

Forms of Venture Capital Assistance:

Venture capital in India is available in three forms. (1) equity, (2) conditional loans, (3) Income motes. All venture capital funds in India provide equity upto a maximum participation of 49% of total equity capital of the firm under which the ownership of the firm remains with the entrepreneur. A conditional loan is repayable in the form of royalty ranging between 2% and 15% after the venture is able to generate sales and no interest is paid on such loans. Income mote has combinational features of conventional and conditional loans. The entreprenuer has to pay both interest and royality on sales at lower rates.

Commercial Banks are also providing venture capital to firms. State Bank of India merchant Banking subsidiary, SBI Capital Markets (SBI Cap) set up a venture capital fund for brought-out-deals. SBI Cap invests in equity shares of new and unknown companies. Canara bank started a venture capital fund through it's can bank financial services. Venture capital fund of Grindlays Bank provides venture capital assistance to high risk projects.

Mutual Funds:

Mutual funds are financial intermediaries which collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies.

Mutual funds have specific investment objectives which are stated in their prospectus. The main objectives are growth, growth income, balanced income and industry specific funds. Growth funds strive for large capital gains, while growth income funds seek both dividend income and capital gains from the common stocks. The balanced fund generally holds a portfolio of diversified common stocks, preferred stocks, and bonds with the hope of realising capital gains, dividend and interest income while at the same time conserving the principal. Income funds concentrate heavily on high interest and high dividend yielding securities. The industry specific mutual funds obviously specialise in selected industries such as chemicals, petroleum or power stocks. Two major categories of mutual funds are the closed-end funds and the open-end funds. The first mutual fund to be set up was the Unit Trust of India in 1964 under an Act of Parliament. At present commercial banks

are also offering mutual funds. State Bank of India, Indian bank, Canara Bank, are offering closed end mutual funds.

6.7 Conclusion:

Banks are now a days taking an active part in providing Industrial finance. Banks provide finance to Industries under term lending, consortium arrangements and participation certificates. There are various schemes for financing small scale industries. Banks are also taking a lead role in rehabilitating sick industries. In recent years, Banks are entering into new fields to finance industry, like venture capital and mutual funds.

6.8 Technical Terms:

Consortium arrangement : Arrangement between two or more banks to share a large loan.

Participation Certificate : An instrument whereby a Bank can sell a part of a loan, advanced to its client to a third party.

Venture Capital : Risky capital

Mutual fund : A fund which collects the savings of investors and invest them in a large and well diversified portfolio of securities.

6.9 Reference Books:

1. Banking theory and Practice - K.C. Sekhar, Vikas Publishing House Ltd.

2. Indian Financial System - H.R. Machiraju, Vikas Publishing House Ltd.

3. Report on trend and progress of Banking R.B.I., 2001-02, 2002-03.

- Dr. V.R. Jyostna Kumari

Lesson - 7

PRIORITY SECTOR ADVANCES

7.0 Objectives:

In this chapter, the author tries to explain the concept of priority sector.

* Performance of various groups of banks in leading to priority sector.
* Impact of reforms on priority sector.

Structure:

7.1 Introduction

7.2 Concept of Priority Sector - Definition of Priority Sector

7.3 Banks Advances to Priority Sectors

7.4 Change of Policy of Banks after reforms

7.5 Summary

7.6 Technical Terms

7.7 Reference Books

7.1 Introduction:

The concept of priority sector was evolved on the basis of what was considered hitherto neglected sector of the economy and was formalised in 1972, on the basis of the report submitted by an informal study group on statistics relating to priority sector, constituted by R.B.I. in May 1971. Priority sector includes those sectors of the economy, which are socially useful, economically viable, but are handicapped for lack of finance on reasonable terms. They include (1) Agriculture (2) small scale industries, (3) Road & Water transport operators (4) Retail trade and small business (5) Professionals and self employed, (6) education and (7) Exports. The first six categories are termed as socially priority sectors, while the Exports Sector is considered as an economic or a National Priority Sector. Initially, the banks were advised in 1974, to lend atleast 33 1/3% of total advances to these sectors. Later in the years 1980-81, on the basis of the recommendation of the working group on the modalities of implementation of the priority sector lending and 20 point economic programme by banks headed by Dr. K.S. Krishnaswamy, the Banks were asked to attain the target of 40% of total to priority sectors by 1985, out of which 40% of total to priority sector advances should be earmarked for agriculture. From then onwards. Public Sector banks are concentrating their efforts to meet the targets of priority sector advances till 1991. When govt started reforms in the Banking Sector with the appointment of Narasimham Committee. The Committee felt that the allotment of priority sector advances, reduced bank's profits and resulted in erosion of capital and inefficient of public sector banks. The committee recommended that, instead of allocating 40% to priority sectors, it should be reduced to 10%. The Banks are now changing their attitude towards priority sectors.

Explanation of the Structure: The structure of this chapter is divided into three main heads. Those heads would be explained as under.

7.2 Concept of Priority Sector - Definition of Priority Sector:

The concept of priority sector was first evolved in the year 1972. In May 1971, R.B.I. constituted a committee on statistics, relating to priority sector, which issued various guidelines indicating the scope of items to be included under the various categories of the priority sector.

The meaning of the "priority sectors" was elaborated at the conference of the custodians of Nationalised Banks held in New Delhi in July 1970, by the then finance Minister in the following words.

"When we talk of priority sectors, the emphasis is on the needs of the common man, who is engaged or willing to be engaged in a productive endeavour, which is socially useful and is economically viable, but is handicapped for lack of finance on reasonable terms."

Thus the priority sectors include those areas of economic activities which are socially desirable, but have earlier either been inadequately financed or wholly neglected by the commercial banks.

They include (1) Agriculture (2) Small scale Industries (3) Road & Water transport operators (4) Professional and Self Employed (6) Education and (7) Exports.

The basic Idea behind the identification of these sectors was to solve the twin problems of poverty and unemployment and to allow a small man to grow and share the fruits of development effort.

In order to facilitate effective accomplishment in the desired direction some schemes, such as credit guarantee scheme, lead bank scheme, differential interest rate scheme and 20 point economic programme were contemplated and brought into force. They have their impact on priority sector lending pattern of the banks.

Although initially, there was no specific target fixed in respect of priority sector lending, the banks were advised in November 1974, to raise the share of these sectors in their aggregate advances to the level of $33^{1/3}$% by March 1979.

Later in the years 1980-81, Targets were fixed for priority sector lending on the basis of the recommendations of the working group on the modalities of implementation of the priority sector lending and the 20 point economic programme by banks headed by Dr. K.S. Krishna Swamy.

The targets were as follows:

(1) Priority sector advances should constitute 40% of aggregate bank advances by 1985. In achieving the target of 40% of total lending to priority sector, by 1985, banks were advised to aim at ensuring that a minimum of 40% of the additional credit flows every year to the priority sectors.

(2) 40% of the total priority sector advances should be earmarked for agriculture and allied activities.

In other words, advances to agriculture would be atleast 15% by the end of March 1985. 16% by the end of March 1987, and 17% by the end of March 1989.

(3) Direct advances to weaker sections in agriculture and allied activities should reach a level of atleast 50% of the total direct lending to agriculture by the end of March 1983.

(4) Advances to rural artisans, village craftman, and cottage industries should constitute 12.5% of the total advances to the small scale industries by the end of March '85.

(5) To disburse a minimum of 1% of the total advances under differential interest Rate Scheme and atleast 40% of there should go to SC/STs and at least 2/3 roles should be made through Rural and Semi urban branches.

Some schemes initiated for effective implementation of priority sector advances.

Goverment initiated certain schemes for the effective accomplishment of priority sector Advances. Those schemes can be explained as under:

I. Credit Guarantee Scheme:

Deposit insurance and credit guarantee corporation provides guarantee cover for small loans given by banks under small loans guarantee scheme (1971) and service co-operative societies guarantee scheme (1971). Small loans given by credit institutions on or after January 1, 1985, are eligible for guarantee cover upto 60% of the amount in default, loans given prior to January 1, 1985, however continue to get guarantee cover upto 75% of the amount in default, subject to the specified monetary ceiling on the corporations claim liability.

II. Lead Bank Scheme:

Gadgil study group set up a National Credit Council (NCC) suggested for the first time to identify those districts where institutional credit was not properly distributed. The group suggested to prepare credit plan keeping in view the area concept. After the nationalisation of commercial banks in 1969 Narasimham Committee was set up and this committee suggested that all the districts should be allocated to the banks and the concerned bank in the district will be accountable for the credit distribution and expanision of banking facilities. 17 large banks were allocated 335 districts. The districts under the bank were supervised and controlled by the bank and the bank was called lead bank. The highest number of districts 89 were allocated to the State Bank of India group and there after 33 districts were allocated to the Central Bank of India. The Lead Bank conducts indepth and extensive survey to know the developmental potentialities in the district and collects information relating to industrial and commercial units. it studies the collection and sale of agricultural produce and formulates credit plan according to the district credit requirements for the various institutional credit institutions.

III. Differential Rate of interest Scheme (DRI Scheme):

The differential rate of interest scheme introduced in 1972, is being implemented by all scheduled commercial banks throughout the country. Under the scheme, bank finance is provided at a concessional rate of interest of 4 percent per annum to the weaker sections for engaging in

productive and gainful activities, thereby enabling an improvement in their economic conditions. Banks are required to lend at least one percent of their aggregate advances as at the end of the previous year under the scheme. Moreover two thirds of the total DRI advances must be routed through the bank's rural and semi urban branches. The annual income ceiling for eligibility is Rs.7,200 per family in urban and semi urban areas and Rs.6400 per family in rural areas. The outstanding advances of PSBs under DRI scheme as at the end of March 2003, amounted to Rs.300 Crores in 3.70 lakh borrowal accounts. The DRI advances of the banks as at the end of March,2003, formed 08% of the total advances, outstanding as at the end of the previous year. In March 2002, which is lower than the relative target of one percent.

7.3 Banks Advances to Priority Sectors:

After the concept of priority sector was evolved in 1972, the targets of priority sector were made applicable to all groups of banks public sector and private sector banks. The foregin banks in India are required to achieve the target of 32% of Net bank credit for the priority sector with sub targets of 10% for small scale industries and 12% of net bank credit to exports.

The following tables show the advances to priority sectors by various groups of banks.

Table - I.

I. Advances to priority sector by Public Sector Banks:

The table 1, shows, advances made by public sector banks to priority sector. As shown by the table, priority sector advances formed 42.5% of Net Bank Credit. While other priority sector Advances registered the largest rise. Direct and indirect advances to Agriculture taken together also registered an increase. Advances to Agriculture constituded 15.3% of Net bank credit as on March 2003.

II. Advances to priority sector by Private Sector Banks:

Advances extended by private sector banks to priority sector are shown in the under given table.

Table - 2

Advances to priority sector by private sectors banks

	March 2001		March 2002		March 2003 (Amounts in Crores)	
	Amount	Percentage of Net bank credit	Amount	Percentage of Net bank credit	Amount	Percentage of Net bank credit
Priority Sector advances	21,567	36.7	25,709	409	36,705	44.4
of which agrriculture	5,634	9.6	8,022	8.5	11,873	10.8
small scale Industries	8,096	13.8	8,613	13.7	6,857	8.3
Other priority Sectors	7,219	12.3	9,074	14.4	17,602	21.3

The above table reveals that, total priority sector advances extended by private sector banks rose as a proportion of Net Bank Credit. The share of other priority sector category was the highest at 21.3 percent of Net Bank Credit, followed by advances to Agriculture and small scale Industries.

III. Advances to priority sector by Foreign Banks:

The targets of priority sector advances were made applicable to foreign banks operating in India. The below table shows the amount of advances extended to priority sector by Foreign banks.

Table - 3
Advances to priority sector by Foreign Banks

	March 2001		March 2002		March 2003	
	Amount (Rs. in Crore)	Percentage of Net bank credit	Amount (Rs. in Crore)	Percentage of Net bank credit	Amount (Rs. in Crore)	Percentage of Net bank credit
Priority Sector advances	11,572	33.5	13,414	34	14,848	33.9
I) Export credit	6,961	20.2	6,948	18	8,195	18.7
2) Small scale Industries	3,646	10.6	4,561	12	3,809	8.7

As shown by the above table lending to priority sector by foreign banks constituted 33.9% of Net Bank Credit as on March 2003. Export credit as a percentage of Net Bank Credit was 18.7%.

Although banks are showing good interest in lending to priority sector, increasing non performing avents are covering a serious concern. The NPAs in case of priority sector advances of public sector banks are Rs.5,749.23 crores as at the end of March 2003, which are 19.39% of the total advances lent to priority sector. In case of private sector banks the percentage of NPAs is little bit better, which as 16.78%.

7.4 Change of Policy of Banks after reforms:

Reforms in the banking sector started in the year 1991, with the appointment of Narasimham Committee. The Committee felt that the policy of priority sector lending resulted in growth overdues and erosion of profitability of public sector banks. Narasimham Committee recommended that this system of directed credit programmes should be gradually phased out. It felt that agriculture and small industries have had already grown to a mature stage and therefore they did not require any special support and therefore it is better to dispense with concessional interest rates. Despite this recommendation, Banks are still lending a good amount of advances to priority sector, keeping their requirement and importance in the economy under Micro finace, banks are lending to small barrowers and self half groups formed by women at concessional rates of interest. It is modest. Indian Banks are contributing a lot for the Development of neglected sectors, despite many problems.

The concept of priority sector was evolved to develop neglected sectors of the economy, which were started of funds. Government thought of providing necessary financial requirements under the concept of priority sector. This concept was first evolved in 1972, on the recommendations of National Credit Council Targets and sub targets were fixed for these sectors. Banks, both public and private sector banks met the targets. Even foreign banks operating in India are also asked to lend to exports. As a part of reform process, the Narasimham Committee felt the need of reducing the target of priority sector advances to 10%. The Committee further felt that it should be slowly phased out. Non performing assests is a major problem in case of priority sector advances. The NPAs are nearly 20% in case of public sector banks and 17% in case of private sector banks. Moreever lending to there sectors at concessional rates affected the profitability of Banks. Despite of these problems, keeping in view, the grave need of funds to there sectors, government is not implementing the recommendation of the Narasimham Committee. Inspite of cooperative banks, these sectors desparately need the credit of commercial banks. So it takes time to reduce the target of priority sector lending.

7.5 Summary:

This chapter explains priority sector lending by Banks exhaustively. The concept of priority section, the targets and sub targets for priority sector are discussed. The progress made by various groups of banks like public sector, private sector and foreign banks are explained at length. All groups of banks met the targets of priority sector lending.

7.6 Technical Terms:

Priority Sector : Import and key sectors of the economy are brought under the concept of priority sector.

DRI Scheme : Differential Rate of interest scheme. Loans to weaker sections at concessional rate of 4% interest.

Lead Bank Scheme : Under this scheme, each bank will be allotted a district in which it takes a lead role.

IPO : Initial Public Offer

NPA Non-performing assets : If an income or principal remain overdue remain overdue for 180 days and is being replaced by 90 days norm.

7.7 Reference Books:

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- Dr. V.R. Jyotsna Kumari

LESSON - 7A

CHANGING PROFILE OF INDIAN BANKING

7A.0 Objectives:

In this chapter, the author tries to explain comprehensively (1) The reforms in the Indian banking sector so as to make students understand:

1) the recent developments in the banking sector
2) the future of Indian Banking

Structure:

7A.1 Introduction
7A.2 Progress made by Commercial Banks
7A.3 Reforms in the Banking Sector]
7A.4 Impact of Reforms
7A.5 Future of Indian Banking
7A.6 Summary
7A.7 Technical Terms
7A.8 Reference Books

7A.1 Introduction:

Indian banking has been subject to so many changes since nationalisation of major banks in 1969. The Indian banking system has undergone a major structural transformation from the one designed to serve mainly large and medium Industries and large business houses to one which supports widespread growth in all the key sectors of the economy. The structure of the organised banking sector is multi dimensional and covers the public, cooperative and private sectors. The public sector in the banking industry dominates and plays a significant role in the overall development of the economy of the country. Nationalisation of banks called for substantial changes in the scale and scope of banking in response to the changes that took place in the social, political and economic environments. Both qualitatively and qualitatively banks have to cater to the multidimensional development of the economy. The phenomenal growth in the scale and scope of the operations of public sector banks, particularly its transformation from “wholesale banking” to “retail banking” has had some adverse affects. Directed credit to weaker and priority sectors at a low rate of interest and statutory preemptions severely effected the profitability of the banks. For improving the efficiency of the banks and to bring about uniformity in the Indian banking structure, so as to make it comparable with the universal standards, a series of reforms were undertaken by the government. In this process, so many changes have taken place in Indian banking. The banking sector reforms have succeeded in earning external constraints under bank operations, introducing transparency in reporting procedures, restructuring, recapitalizing banks and enhancing the competitive element in the market through the entry of new banks. Adoption of Information Technology is one of the important changes in the Indian banking sector, which introduced Electronic banking.

7A.2 Progress made by Commercial Banks:

Indian banking witnessed good progress especially after economic reforms, in regard to branch expansion, Deposit mobilisation, Advances etc.

Branch expansion: The progress made by Indian banks in regard to branch expansion is shown in the following table.

Table-I

	96-97	97-98	98-99	99-00	2000-01	01-02	02-03
Public Sector Banks	44756	45289	45860	46285	46323	46384	46752
Private Sector Banks	4462	4793	4792	4802	5233	5311	4749
Foreign Banks	176	180	172	181	190	194	194
Total	49394	50262	50824	51268	51746	51889	51695

Source: India Bank's Association: Performance highlights of Public Sector, Private Sector and Foreign Banks.

As shown by the above table, banks made good progress in branch expansions. In a period of 5 years, branches more by nearly 2000. The branches of private sector and foreign banks also increased by a sizeable number, due to the liberalisation policies adopted by government.

Deposit mobilisation: Wide network of bank branches and liberal policies gave a greater fillup to deposit mobilisation. The trend of increase in deposits and advances of banks are shown in the tables 2 and 3 respectively.

Table - 2
Deposits

(Rs. in Crores)

	96-97	97-98	98-99	99-00	2000-01	01-02	02-03
Public Sector Banks	4,26,465	5,04,064	6,07,268	7,06,043	8,30,314	9,36,014	10,48,640
Private Sector Banks	51,039	69,516	83,252	1,13,471	1,36,470	1,67,945	2,06,914
Foreign Banks	37,394	43,447	46,476	49,324	59,190	64,503	69,313
Total	5,14,898	6,43,096	7,36,996	8,68,838	10,25,974	11,68,462	13,24,867

Source: Indian Bank's Association: Performance highlights of Public Sector, Private Sector and Foreign Banks.

Table - 3
Advances

	96-97	97-98	98-99	99-00	2000-01	01-02	02-03
Public Sector Banks	68,930	80,574	93,713	1,08,209	1,27,015	1,46,865	1,76,645
Private Sector Banks	8,451	9,975	11,722	14,558	16,636	19,702	31,074
Foreign Banks	4,738	5,437	6,474	7,693	9,222	10,484	11,065
Total	82,119	95,986	1,11,909	1,30,460	1,52,874	1,77,051	2,19,324

Source: Indian Bank's Association: Performance highlights of Public Sector, Private Sector and Foreign Banks.

As shown by the tables shown above, banks showed good progress in regard to deposits and Advances respectively.

7A.3 Reforms in the Banking Sector:

Despite the impressive quantitative achievements in resource mobilisation and in extending credit reach, several distortions had crept into the banking and financial system. The prevalence of high reserve requirements interest rate controls and allocation of credit to priority sectors increased the degree of financial repression. The portfolio quality of the banks had badly deteriorated and the profitability had been eroded which ultimately affected the performance of the banks.

Under these circumstances, the government of India set up a high level committee with M. Narasimham, the former governor of R.B.I. as chairman to examine all aspects relating to structure, organisation, functions and proceedings of financial system. The Narasimham Committee-I in 1991 provided the blue print for the first generation reforms of the financial sector. During 92-97, govt. started laying foundation for the reforms in the banking sector. Narasimham committee II in 1998 provided the road map for the second generation reform process. Two points are worthnoting at this juncture. First financial sector reforms were undertaken early in the reform cycle and secondly the reforms in the financial sector were initiated in well structured sequenced and phased manner with cautions and proper sequencing, mutually reinforcing measures, complementarity between reforms in the banking sector and changes in fiscal, external and monetary policies, developing financial infrastructure and developing financial markets.

In the light of the Narasimham Committee-I (1991) and Narasimham Committee II (1998) reports on financial sector reforms, comprehensive reforms were whered into the Indian banking sector with the objectives of enhancing efficiency, profitability and productivity for a sound and stable financial system. The major reforms intiated in the banking system were:

1. Prudential norms and capital adequacy measures in line with international standards.
2. Gradual reduction of cash reserve ratio and statutory liquidity ratio.
3. Mergers, Entry Exit and interest rate deregulation.

4. Banks were permitted to access capital markets to meet their funding requirements.
5. Reduction of non-performing assets (NPAs) and introduction of voluntary retirement schemes for reducing surplus staff.

These reforms can be explained in detail as under:

I. Directed credit programmes:

A major objective of banks nation in July 1969 was to extend bank credit to reflected sectors like agriculture, small business etc designated as priority sectors. Banks were asked to divert loans to there directed programmes. They were also told to shift security oriented credit to purpose oriented credit. Accordingly commercial banks lent loans to these sectors. But the policy of priority sector lending resulted in growth of overdues and erosion of profitability of public sector banks. Narasimham committee recommended that this system of directed credit programmes should be gradually phased out. It felt that the agriculture and small industries have already grown to a nature stage and therefore they did not require any special support and therefore it is better to dispense with confessional interest rates. The committee also proposed to redefine priority sectors and it should include only the weakest sectors like marginal formers, rural artisans, village and cottage industries and tiny sectors etc. The credit in this direction should be 10% of total bank credit.

II. Non-Performing assets:

The most vexed issue in Indian banking is of non-performing assests. The public sector banks in India carry highest NPAs. The given below table shows NPAs of banks.

Table - 4
N.P.As as a percentage of total assests of banks

	98-99	99-2000	2000-01	01-02	02-03
Public Sector Banks	3.14	2.94	2.72	2.42	1.94
Private Sector Banks	2.83	2.3	2.27	2.49	2.32
Foreign Banks	1.10	1.03	0.77	0.81	0.79

Source: Indian Bank's Association: Performance highlights of Public Sector, Private Sector and Foreign Banks.

The above table shows some decline in NPAs as percentage of total assets across all commercial banks in India from 98-99. The root problem of NPAs of banks is that there is a sizeable overhang component arising from the weak debt recovery processes, inadequate risk management techniques etc. The government and Reserve Bank of India brought in legislation to provide the debt Recovery tribunals Lok Adalats and ARC (Asset Reconstruction Company) for reducing and taking the NPAs out of the banks balance sheets, as recommended by Narasimham Committee.

III. Direct investment measures:

The basic principle of sound banking is maintenance of adequate liquid assests. As per banking regulation Act 1949, banks are required to maintain a minimum of 25% of liquid assests in the form of cash, gold, government securities etc. This requirement is known as statutory liquidity ratio and the RBI has power to vary this ratio from 25% to 40%. The SLR was 30% in 1972 and it was increased to 38.5% by 1991. The Narasimham Committee argued that the high SLR adversely affected profitability of banks. Therefore the Narasimham Committee recommended the government to give up immediately the practice of using SLR as a major source of mobilizing funds for government and it recommended to reduce SLR from 38.5% to 25%. Responding to it the government of India has reduced the SLR from 38.5% in 1991 to 25% in 1997.

Cash Reserve Ratio:

As per the R.B.I. act, 1934, every commercial bank has to keep certain minimum cash reserves with the R.B.I. initially it was 5%. The RBI is empowered to vary the CRR between 3 and 15%. The CRR has been changed many times. By 1991 the CRR was raised to its maximum limit of 15%. The Narasimham committee recommended the government to rely more on open market operations rather than CRR and it proposed to the government to reduce CRR from the present high level 15% to 3.5%. Accordingly the government has reduced the CRR from 15% in 1991 to 10.5% in 1997, 8.5% in 2000 and 8% by March 2001. Further the Narasimham committee also recommended the government to pay a minimum rate of interest equal to the level of bank's one year deposit.

IV. Prudential norms:

Prudential norms have been started by R.B.I. as a part of the reformative process. The purpose of prudential system of recognition of income, classification of assests and provisioning of bad debts in to ensure that the books of the commercial banks reflect their financial position more accurately and in accordance with internationally accepted accounting practices. As per the R.B.I., prudential norms the banks are required to make 100% provision for all NPAs.

V. Mergers and Acquisitions:

Narasimham Committee recommended for bigger banks rather than week, small banks. The Committee felt the need of merging week banks with strong banks. In September 1993, government of India passed an ordinance and merged New Bank of India with Punjab National Bank, but it is not a success story government of India made few attempts of merger to save the week banks. In November 1999, HDFC took over Times bank and created history in the banking sector.

Some mergers are:

1. New Bank of India with Punjab National Bank in 1993
2. HDFC Bank took over Times Bank in 1999
3. ICICI Bank with Bank of Madhura in 2000
4. GTB with oriental Bank of Commerce in 2004. (Global Trust Bank)

VI. Public Sector Banks - Disinvestments:

Narasimham Committee recommended for minimum capital adequacy for Indian banks, which is fixed at 8% and later raised to 9%. In order to enable public sector banks to satisfy capital adequacy norms, as per international guidelines, recapitalization was initiated in 1993 aggregating Rs.20,446 crores. There has been further infusion of capital as public sector banks are allowed to approach the capital market. In December 1993 and January 1994, the SBI raised Rs.200 crores from public through the issue of equity and another Rs.1000 crores through the issue of bonds. A number of public sector banks like the bank of Baroda, Canara bank, Andhra Bank, Punjab National Bank etc have sold shares in the capital market. The government holdings in public sector banks as in September 2003, varied between 57.2% (Corporation Bank) to 80% (Punjab National Bank). In SBI, the promoters holdings are 59.7%. The rest is held by public, foreign investors, financial institutions body corporates etc. The net result of the dilution in ownership in PSBs is that these banks are becoming joint sector banks.

VII. Foreign Direct Investment:

The government has been pursuing an open door policy and opened the flood gates for the inflow of foreign capital in the form of Foreign Direct Investment (FDI) investments by foreign institutional investors etc in the banking sector too. FDIs are also permitted in Indian banks, but it was limited to 49% of the capital, but now raised to 74% facilitating setting up of subsidiaries of foreign banks and attracting investment in private sector banks. The Indian banks with low capital adequacy ratio will have the option to raise capital from overseas investors. Presently, Indian banks which can offer stake to foreign investors are Global Trust Bank, Indus Bank, and Bank of Punjab. Banks like ING Vysya and Centurion Bank may further increase the stake of foreign investors.

VIII. Banks - Information Technology:

Another major change that the reforms brought in the banking sector is wide application of information technology. Many Indian banks are offering facilities like ATA Network, Any where/Any time banking, tele banking. Home banking, on - line banking, Internet banking, Virtual banking and universal banking etc. Many of the banks have diversified their activities in business areas like leasing, venture capital, mutual fund, housing finance, insurance, merchant banking and factoring etc. It is imperative that banks should go for the use of I.T. to meet the ever growing demands of the customers with the increasing thrust for communication Technology a major break through has taken place in 1999 with the establishment of Indian Financial Network (INFINET) by using the technology of the Institute for Development and research in Banking technology of Hyderabad. The institute has been set up by the R.B.I. to promote research and development in various aspects of banking technology. The technology adoption in Indian banks was a process which stemmed out of recommendations of the Committees formed by the R.B.I. The first two committees in 1983 and 88 respectively were set up under the chairmanship of Dr. C. Rangarajan, then Deputy governor of R.B.I. The third committee was formed in 1994 under the Chairmanship of Sri Saraf, then Executive Director of R.B.I. Besides the issue of technology adoption in Banks was also examined in detail by the financial reforms committee set up by the government of India in 1991 and 1998 headed by Sri M. Narasimham. The recommendations of Narsimham Committee were further reviewed for implementation by R.B.I. Committee on technology issues under the chairmanship of Dr. Vasudevan, the then Executive Director of R.B.I. Almost many recommendations of the above committees have

been accepted by R.B.I. and are being implemented now in the banking industry. At present banks are providing many innovative services that are based on technology. Some of them are

1. Automated Teller Machines (ATMs)
2. Any branch money/Any time banking
3. Internet Banking (IB)
4. Electronic Fund Transfer (EFT)
5. Electronic Customer Entry System (ECES)
6. E-banking
7. Credit cards/Debit cards/Smart cards.
8. Home office Banking System (HOBs)
9. Tele banking/Mobile banking
10. Inter Bank Online System (IBOS)
11. Society for Worldwide bank Financial Tele communication (SWIFT)
12. Inter branch Reconciliation (IBR)
13. Indian Financial Network (INFINET)
14. Electronic Clearing Service (ECS)
15. Total Branch Computerisation (TBC)

Indian banks are mainly facing two hurdles in the implementation of information Technology. One is heavy initial cost involved in implementation of I.T. and another is poor communication infrastructure in various parts of rural India.

IX. Basel II accord:

Another prominent issue which banks just can't ignore is the Basel II accord and its implications. Two important implications of Basel II accord are one capital efficiency and second one is market discipline. Efficient use of capital will determine returns on equity and consequent enhancement of shareholder's value. In effect, future plans may therefore include efficient use of capital, an approach that has been called the "just-in-time balance sheet" management", in which capital flows quickly to its most efficient use. The accord also stresses on market reliability. Banks have to rely on markets to assess their riskiness. There should be increased focus on transparency and market disclosure, critical information describing the risk profile, capital structure and capital adequacy.

X. Corporate Governance in Banks:

The Basel Committee in 1999 has brought out certain important principles in corporate governance for banking organisations. The committee underscores the need for banks, to set the strategy for their operations and to establish accountability for executing the strategy. Unless there is transparency of information related to discussions and actions, it would be difficult for stake holders to make managements accountable. Accountability should extend to all levels including the boards. Corporate governance includes the member of board of Director of banks, who govern the business and affairs of the individual institutions and their functional relationship with the senior management. The board largely sets the following.

1. Corporate objectives

2. The type of business, the institution may undertake
3. Recognise and protect the interest of shareholders i.e. employees, customers, suppliers, regulatory authorities government etc.
4. All the activities of the organisation would operate in a safe and sound manner and in compliance of applicable laws. Depositors interests should be protected.

7A.4 Impact of Reforms:

Reforms resulted in a diversified banking system. Besides the growth of commercial banking system, one can find the emergence and growth of a number of other financial intermediaries such as mutual funds, non banking financial companies, primary dealers, housing finance companies, to mention a few. Both public and private sector banks played a significant role in promoting these institutions financial conglomerates deeling in many financial services and products have emerged. For example, the State Bank of India is now dealing in insurance, long term finance equities trading, assets management and housing finance. The HDFC is dealing in housing finance, retail banking, Insurance and Securities and trading. Majority of commercial banks are offering remote banking services through Automatic Teller Machines (ATM) and Electronic banking facilities.

Prudential regulations like higher provisioning norms, tighter asset classification norms, guidelines for debt recovery/restructuring, lowering of ceilings to exposure to a single borrower etc are having the desired effect. They have ensured stability even in the force of both external and internal uncertainties.

As part of the reforms, the supplemental agreement between the government and the R.B.I. on the abolition of adhoc treasury bills eliminated the automatic monetization of government deficit in the late half of 90s. The R.B.I. moved away from micro regulation of credit to macro management.

Improvement in the quality of the assests of the banks has been the most note-worthy feature of financial performance of banks in the post reform period. The profitability of public sector banks has improved. The ratio of net profits to total assests of scheduled commercial banking increased by 0.11% that of public sector banks by 0.14%, while that of private sector banks also by 0.14% during the reform period between 91-92 and 2000-2001. It is also interesting to note that 25 out of 27 public sector banks and 28 out of 31 private banks have achieved the minimum stipulated capital adequacy ratio of 9%.

7A.5 Future of Indian Banking:

In India, till the eighties, the banks were operating in protective environment characterized by administered interest rates, high level of pre-emptying in the forms of reserves requirements and direct credit. The accent of reform process was to improve productivity and efficiency of the financial system and provide a competitive environment. Despite liberalisation, government intervention in the financial sector is still apparent. The R.B.I. regulates the entry of foreign banks and all banking activities under the banking regulations act of 1949 and foreign regulation Act of 1973. However as part of India's commitment to the W.T.O. under the new financial services agreement (1997) India has agreed to allow up to 12 licenses a year for foreign bank branches. In actual practice, India has allowed foreign banks to open 15 branches in a year. In addition off site ATMs which require a branch license are outside this limit of 12. Therefore the introduction of liberdisation measures in the banking sector and the emergence of new private and foreign banks equipped with a latest

technology led to an increase in competition in the banking sector. Another significant factor determining the competitiveness is the customer service. Customer satisfaction is essential for survival. The banks will emerge as the winners in implending era will be truly customer-centric banks.

7A.6 Summary:

The above chapter thoroughly discusses the impact of reforms on the Indian banking sector. Reforms first started in banking in 1991, with the appointment of Narasimham Committee. Narasimham Committee felt the need of drastic changes in the present working of banks. Reduction of statutory liquidity ratio, cash reserve ratio, prudential norms of assests classification, capital adequacy norms for banks are some of the recommendations. Again in 1997, Narasimham Committee made some other recommendations . Basel accord in 1998 brought the concept of capital governance in banks. There reforms brought so many changes in the banking sector. Bank are freed from the administered interest rates, statutory requirements and other regulations. Private sector banks and foreign banks got more freedom to open branches. The advent of information technology improved customer service. The future of Indian Banking is in a competitive environment.

7A.7 Technical Terms:

Priority Sector : Import and key sectors of the economy are brought under the concept of priority sector.

DRI Scheme : Differential Rate of interest scheme. Loans to weaker sections at concessional rate of 4% interest.

Lead Bank Scheme : Under this scheme, each bank will be allotted a district in which it takes a lead role.

IPO : Initial Public Offer

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LESSON - 8

MERCHANT BANKING

8.0 Objectives:

The objectives of this chapter are to give a lucid understanding about

* Merchant Banking activities in India
* Current trends in Merchant Banking
* Functions of Merchant Banks
* Regulations of SEBI and R.B.I. governing Merchant Bankers
* Responsibilities and code of conduct for Merchant Bankers

Structure:

8.1 Introduction
8.2 Merchant Banking activities in India
8.3 Current trends in Merchant Banking
8.4 Functions of Merchant Banks
8.5 Regulations Governing Merchant Bankers
8.6 Responsibilities of Merchant Bankers
8.7 Code of Conduct
8.8 Responsibilities/Obligations of Lead Managers
8.9 Summary
8.10 Key Words
8.11 Reference Books

8.1 Introduction:

Merchant Banking refers to activities related to underwriting corporate securities and advisory services. An organisation which undertakes these activities is called 'Merchant Bankers'. The range of activities of merchant banks are very wide. The Merchant Banks are also known as "Investment Banks" in the U.S. and accepting and issuing houses in the U.K. They provide a variety of financial services and finance. They deal with management of public issues, loan syndication, project counselling, arranging international finances, mergers and amalgamations, consultancy to sick units for revival and also management buyer and buy-out. The various activities undertaken by merchant bankers could be broadly divided into two categories. The fund based activities encompass dealing in 'money market instruments like the placement of commercial papers, fixed deposits and treasury bills etc, equipment leasing, dealing in secondary market operations, intercorporate placement of funds and venture capital fund. The non-fund based activities consist of the following capital issue related activities, private placement, project councelling, broking, underwriting, mergers and acquisitions and arranging international finance.

For a better understanding the mature of Merchant Banking, we can compare it with commercial banking. Merchant Banks offer mainly financial advice and service for a fee. While Commercial Banks accept deposits and lend money. Merchant Banks also function as commercial banks, but as wholesale bankers, rather than retail bankers. They deal with selective large industrial clients and not with general public in their fund based activities. The Merchant Banks are different from securities dealers, traders and bankers. They deal mainly in new issues, while they latter deal mainly in existing securities. The Merchant Banks are engaged more in broking than in banking business. They arrange funds or negotiate financial deals for their clients for a fee as brokers or intermediaries.

The basic function of Merchant Banks is marketing corporate and other securities, that is guaranteeing sales and distribution of securities. All aspects - organisation, underwriting and distribution of the sale of Industrial Securities are handled by them. Merchant Banks are experts and good judges in dividing the timings and terms of issue. They can estimate market conditions and investors preferences. They guarantee the success of issues by underwriting them. They provide all the services related to receiving applications, allotment, collecting money, sending share certificates and so on. The Merchant Banker does not normally assume all the risk himself, while underwriting the issue. There is usually the practice of forming a syndicate of a group of Merchant Bankers to sell different issues.

8.2 Merchant Banking activities in India:

In India, Merchant banking activities started from the year 1967, following the pattern of similar activities in the U.K. and U.S.A. In India, the Merchant banking activities are provided by the following types of organisations.

1. Commercial Banks:

Many nationalised banks either operate separate divisions or have floated wholly owned subsidiaries to carry out merchant banking activities. The S.B.I. was the first bank to begin to offer there services in 1972. Some other banks entered this field, following the Foreign Exchange Regulation Act (FERA) regulations in 1973 which required a large number of foreign companies to dilute their share ownership in India. By now, S.B.I., Canara Bank, and Bank of Baroda have floated wholly owned subsidiaries namely S.B.I. Capital Market Ltd (SBI CAP) Can Bank Financial Services Ltd. (Can Fina) and Bank of Baroda Fiscal Service Ltd. (BOB Fiscal) respectively for carrying out there activities. Among foreign banks, Grindlays bank has been offering there services since 1967, through a specialised division. At present most of the foreign banks are offering there services. They have been active in the area of arranging and syndicating foreign currency loans and attracting foreign investments to India. They have been providing advisory services and other types of assistance to foreign companies descrying to set up joint ventures in India.

2. All India Financial Institutions:

Among development banks, the Industrial credit and Investment Corporation of India was the first to set up a Merchant Banking division in 1974. It offers wide range of services such as project counselling, loan syndication, lease finance managing issues of securities, venture capital assistance and so on. IDBI and IFC also have entered this field.

3. Private Consultancy Firms:

Organisations such as DSP Financial consultants, Credit Capital Finance Corporation Ltd, J M Financial and investment services Ltd. have also been active in this field. They provide advisory services to NRIs, assistance in international finance managing services for fixed deposit schemes of companies assistance in private placement of securities, advice in intercorporate investments and so on.

4. Technical Consultancy Organisations:

These organisations have been set up in many states with the intiative of all India Financial Institutions. Among other things they provide merchant banking services to medium and small sized units.

8.3 Current trends in Merchant Banking:

In India, various banks including Grindlays Bank, Citi Bank, State Bank of India, ICICI etc. are engaged in Merchant banking activities. They usually carry out functions, such as the management of funds, financing of foreign trade, advising companies on raising capital, undertaking foreign security business etc. considering the cost of raising funds, the specialised nature of issue house activities, the requirement to deal with various regulatory organisations like the SEBI, stock exchange and R.B.I. etc, companies are now appointing Merchant bankers as their lead Managers for public issue activities. So Merchant bankers are now flourishing by undertaking “open offer” business. Companies like Nagarjuna Financial Services Ltd. have taken the lead in handling open offers during the year 1999. The NFSL has handled as many as seven open offers. The country’s leading share registrars and share broking house Karvy consultants on the other hand have been doing well on the open public issue front. The Merchant Bankers point out that it takes only 120 days for the entire take over process to be completed. While amalgamations and mergers under the traditional method take are to two year’s time. Companies like Karvy consultants, NSDL and CIL Securities Ltd. have brought in Rs.5 Crore for undertaking fee based activities coming into force. The domestic Merchant bank, major SBI capital markets (SBI CAPS) has started its banking business after its merger with SBI securities in 1999. SBI securities, fully owned subsidiary of the State Bank of India has been formed to look after the broking business as a separate entity. The number of Merchant banks, managing the business continues to durindle rapidly with only 71 doing any business in 1998-99. This is in sharp contrast to the situation many years ago, when over 1000 merchant bankers jostled for business. The down turn started about over five years ago. Among the successful merchant bankers D.S.P. Merrill lynch Ltd. has emerged as top merchant banker in 1998-99 for funds mobilised through all types of issues including public issues, right issues, private placement of corporate debt, preference shares and PSU equity disinvestment.

8.4 Functions of Merchant Banks:

Merchant Banks perform a variety of functions. They can be broadly explained as follows:

1. Project Reports and Appraisals:

Pre project activities carry three distinct stages. A pre feasibility report (PFR) Techno Economic feasibility Report (TEFR) and a Detailed Project Report. Every project has its own critical

issues, such as technology, trained manpower, market and management. A project consultant has special responsibility to identify such critical issues and other aspects such as technical feasibility production processes, line balancing and so on are required to be looked into. Technical analysis includes the suitability of land identified, the building infrastructure, power, water communication etc. The failure of Indian companies in the part has been due to improper assessment of market potential rather than technological aspects. In the case of consumer goods, the cost of marketing may be more than their production cost and therefore without relying on traditional accounting methods, a proper exercise should be syntherised, so as to arrive at the marketing cost. A detailed market survey by professional institutions may be required. In a competitive environment, core competencies are important. Core competence is an instrinsic valve addition obtaining in a project and it cant be easily replicated the deployment of other resources like money or human resources. The cost of the project and means of the finance, capital budgeting break-even analysis, projecting the resale value of assets. Economic value added (EVA) and market value added projections, Social cost benefit analysis, environmental impact are all other aspects that should be taken care of. Cost and time overruns should invariably be avoided. Technology assessment is a critical area. Improper/obsolete specifications are often the major reasons for high costs and delays. Incorrect estimation of project costs is also one of the fundamental reasons for over runs. Project reports should therefore be based on the creative and imaginative adaptation of time tested project management principles to specific situations. Merchant Banker help companies in the preparation of project reports. Their expertive would go a long way in avoiding overruns, delays, in project reports.

2. Loan Syndication:

This is related to the services rendered in the procurement of term loans and working capital loans from financial institutions, banks and other investment firms from clients. The syndication of loan consists of preparation of project reports, scouting for location or identification of the source of finance, viability of the proposal, preparation and filing of loan applications, supplying the required information for appraisal of the proposal. Merchant bank renders all these services starting from applying loan to final disbursement of the loan to the client. The cost of syndication is likely to vary with credit risk. Borrowers of high credit standing are likely to get the best terms. Syndication make far efficient pricing and is administratively easier. In a loan syndication, the barrower approaches several banks that might be willing to syndicate a loan, specifying the amount and tenure for which the loan is to be syndicated.

3. Capital Structuring:

Financing is concerned with an important function, namely raising funds for firms. The funds raised may be long-term or short-term. A firm has to minimise the overall cost of capital and only this can enable it to maximise profitability and add value to the firm. This in turn helps maximise Earnings per share (EPS). The close nexus between the judicious are of debt and market value of the firm should be recognised. This is because the debt equity mix or financial leverage has implications for the shareholders earnings and risk. The capital structure division is influenced by a number of factors, that are highly psychological complex and qualitative in nature capital structure policy involves a choice between risk and expected return. The optimal capital structure strikes a balance between there risks and returns and thus examines the price of the stock. The companies that do not design their capital structure in a pre planned, way face difficulties in raising funds on

favourable terms. The Merchant banker prepares the capital structure of the firm and helps the firm in overcoming the difficulties involved in the preparation of capital structure.

4. Depository Services:

Merchant banks offer depository services. In a depository system, the transfer and settlement of scrips take place through effecting the transfer of ownership of securities by means of book entry, without the physical movement of scrips. The electronic book entry system, facilitates automatic and transparent trading in scrips. It also allows for reduction in settlement periods and contributes to the liquidity of investments in securities. The eligible institutions should register with SEBI before they provide depository services. Depository services are made available in respect of securities specified by SEBI. The securities Industry intermediaries are also able to avail the benefit of standardised communications between the depository, registrars and other intermediaries. More sophisticated custodial services are offered to small investors. Merchant banks like NSDL, Stock Holding Corporation of India Ltd and other eligible institutions provide electronic depository services for securities traded in the equity and debt markets of the country. The SEBI has stipulated that the following can be registered as depository participants, brokers with a minimum net worth of Rs.50 lakhs and NBFCs and individuals dealing for their own account with a minimum portfolio of Rs.5 crore.

5. Disinvestment:

Merchant banks are also assisting the government in its disinvestment process. As a part of reforms, government started disinvestment process in 241 public sector units in a phased manner. Government hand over the disinvestment mandate to Merchant banks. All registered merchant banks can participate in bidding for mandates of disinvestment by government.

6. Venture Capital:

Venture capital is a new financial service, which helps new entreprenuers proposing new technology or products. The projects are risky, but have the potentials of high return. The capital is committed in the form of shareholdings for the formatting and setting up of firms specialising in new ideas or technologies. Active involvement in the management of the company is required and this is mostly performed through the membership of the board of directors. Venture capital companies are promoted by Merchant Banks. All India financial institutions, commercial banks and also by companies in the private sector. The assistance involves setting up of pilot projects, technological innovations and modernisation, meeting the cost of surveys and market promotion programmes. SEBI has modified venture capital guidelines. Apart from financial institutions Kotak Mahindra Finance Ltd. has firmed up plans to set up venture funds. ICICI venture, VTI India in Technology venture fund and the Andhra Pradesh Industrial Development Corporation (APDIC) venture fund approached SEBI for permission.

8.5 Regulations Governing Merchant Bankers:

The Securities Exchange Board of India and Reserve Bank of India impose restrictions orgulations governing Merchant Banks. SEBI introduced sweeping changes in the regulations

governing Merchant banking companies in June 1997 to weed out inactive or non-serious merchant banking outfits. Those changes are as follows.

1. Minimum net worth criteria is raised. Merchant bankers are prohibited from carrying on fund-based activities like learning and hire purchase. Multiple categories of merchant bankers are abolished.

2. Merchant bankers who are undertaking portfolio management have to take separate registration in future.

3. There changes were proposed in the light of criticism that SEBI was not firmly against a large number of merchant bankers who had only acquired license, but were not contributing any business. It was noted nearly 148 merchant bankers were in business only on paper. The proposal to increase the existing networth from Rs.5 crore to Rs.15 crore was however not approved due to opposition from AMBI Board.

4. On September 5, 1997, SEBI banned Merchant Bankers and NBFCs from straying into one another's territories. Merchant bankers now can't carry on fund based activities anymore, they can't accept deposits or undertake activities like learning, bill discounting and hire purchase.

5. In December 1997, SEBI amended the regulations of Merchant bankers and added some new provisions. There prescribe that an applicant can carry on the activity as underwriter only if he obtains a separate certificate of registration under the SEBI underwriter's regulations. Similarly for carrying on the activity as portfolio manager a separate certificate of registration has to be taken under the SEBI portfolio manager regulations.

6. According to a new regulation vide BA, No merchant banker other than a bank or a financial institution, who has been granted a certificate of registration under there regulations shall carry on any business other than that in the securities market.

7. In February 1998, the Reserve Bank of India exempted merchant banking companies from the provisions of the R.B.I. act 1934, relating to compulsory registration maintenance of liquid averts, creation of a reserve fund, and all the provisions of the recent directions relating to deposit acceptance and prudential norms. Merchant banking companies, in order to be eligible for exemption should be registered with SEBI under section R of the SEBI act. They should not carry any other financial activities as mentioned in section 45(1)(c) of R.B.I. act 1934 and they should not accept or hold public deposits.

8. As regards raising funds by merchant bankers, it was clarified that a merchant banker may raise money by the issue of secured debentures/secured bonds/ICDs. In view of the restrictions on the activities of merchant banker, he should not undertake any business other than that in the securities market. If he undertakes such activities, he has to discontinue such activities or transfer the merchant banking activities to a new entity. And the new entity should be registered with SEBI as merchant banker.

8.6 Responsibilities of Merchant Bankers:

With a view to protect the interests of investors and also for ensuring transparency in the operations, a number of obligations and responsibilities have been imposed on merchant bankers. There are as follows:

1. Entering into an agreement with a corporate body setting out their mutual rights, liabilities and obligations, relating to an issue, particularly on disclosures, allotment, and refund, maintenance of books of accounts, submission of half yearly reports to the SEBI etc.

2. Merchant bankers are responsible for the verification of contents of a prospectus or the letter of offer in respect of an issue and are required to submit to the SEBI a due diligence certificate confirming that disclosures made in the draft prospectus are true, fair, adequate to enable the investor to make a well informed decision.

3. SEBI is empowered to suspend the registration of a merchant banker, in case the merchant banker furnishes wrong or false information, fails to resolve the complaints of investors etc.

8.7 Code of Conduct:

The code of conduct for members of the Association of Merchant bankers was released at the fourth Annual General Meeting held in 1997 and it was accordingly decided that.......

1. Merchant bankers should take adequate measures to ensure that confidential price-sensitive information given to them is not used for the purpose of 'insider trading' by them or their employees.

2. The code covers a variety of issues such as regulatory/statutory compliance, confidentiality, accurate records, financial record keeping, conflicts of interests, ethics in conducting the business, political contributions, communication, public disvosure disparagement of competitors, marketing, discrimination, contracts with clients, expenses reimbursement, trade secrets, compliance responsibility and quality performance.

3. The code also insists that all advice that suppreces or does not disclose the material nature of transaction should be avoided as being prohibited.

8.8 Responsibilities/Obligations of Lead Managers:

A Merchant Bank which acts as a lead Manager, has the following responsibilities towards the issuing company, SEBI and its own profession. They are as under.

1. Enter into a contract with the issuing company, clearly specifying their mutual rights, obligations and liabilities, relating to the issue, particularly relating to disclosures, allotment and refund.

2. Submit a copy the above contract to SEBI atleast one month, before the opening of the issue for subscription. In case of more than one lead manager, simultaneously submit a statement explanning their respective responsibilities.

3. Refuse acceptance of appointment as lead manager, if the issuing company is its associate.

4. Do not associate with a merchant banker who does not hold SEBI registration certificate.

5. The minimum understanding commission is 5 percent or 25 lakhs whichever is less.

6. Submit due diligence certificate to SEBI at least two weeks before the opening of the issue for subscription.

7. Submit to SEBI, various documents such as particulars of the issue, Draft prospectus/letter of

offer and other literature to be circulated to the investors/shareholders etc at least two weeks before the date of filing them with the registrar of companies and regional stock exchanges.

8. Ensure that modification and suggestions made by SEBI, regarding above documents have been duly incorporated.

9. Should associate with the issue till the subscribers have received share/debenture certificates or the refund of excess application money.

10. Not to acquire securities of any company on the basis of unpublished price sensitive information obtained in the course of discharge of his professional assignment, whether obtained from the client or any other person.

11. Submit full particulars to SEBI within 15 days of the acquisition of securities of the company whose issue the merchant banker is managing.

12. The lead manager should disclose the following to the SEBI.
    1. His responsibilities regarding the management of the issue.
    2. Any change in the information/particulars previously furnished with SEBI having bearing on certificate of registration granted to it.
    3. Details relating to the branch of capital adequatly norm.
    4. Names and address of the companies whose issues he has managed or has been associated with, and
    5. Information regarding his activities as manager underwriter, consultant or advisor to the issue.

8.9 Summary:

Merchant banking is synonymous with financial services. Merchant banks undertake various services such as project appraisals, loan syndication, capital structuring depository services disinvestment and venture capital. Merchant bankers are regulated by many regulations/acts, like provisions of companies act, listing guidelines of stock exchange, securities contracts (Regulation) Act, 1956, FERA etc.

Merchant bankers as lead managers enter into contracts with companies that propose to issue shares/debentures etc. Category I merchant bankers have to accept a minimum underwriting obligation of 5 percent of the total underwriting commission of Rs.25 Lacks whichever is less. A due diligence certificate about the verification of the contents of the prospectus, in respect to an issue should be submitted to SEBI. He arranges for the appraisal of the project report by banks/Financial institutions, gives opinion on debt equity ratio, decides the name of the bankers, registrars, underwriters, brokers, printers, advertisement agencies, quantum of premium to be charged where applicable. Fixing of opening and closing dates of the subscription lists, arranges the collection reports and finally the allotment of shares after obtaining the approvals of stock exchanges. Thus he acts as a principal agency in so far as it concerns pre issue and past issue management activities of public issues.

The functions of Merchant bankers are performed by financial institutions, private sector banks, foreign banks, private and independent merchant bankers and banks subsidiaries, private merchant banks are mostly visible Mondays. Equity and debentures continue to be the market -

preferred instruments. A successful public issue management is evaluated on the basis of three factors, mainly the date within which the issue is oversubscribed, the number of times it is oversubscribed, and costs incurred in the public issue. When an issue is oversubscribed several times, it speaks of the investor's confidence in the company as well as managers to the issue. Proper marketing, pricing and publicity, strategies formulated by the managers to the issue determine the success of the issue. Among the top five merchant banks in India, SBI caps Ltd. continued to be the market leader.

8.10 Key Words:

1. SEBI : Securities and Exchange Board of India.
2. Loan Syndication : The process involved in the sanction of the loan.
3. Lead Manager : Taking initiative in issue of securities to public.
4. Venture capital : Investing in risky securities.
5. Disinvestment : Taking back the investment in public sector companies by the government. Government sells away the equity in public sector units to private parties or public.
6. Capital Structure : Proportion of Debt and Equity in the capital.
7. EPS : Earnings Per Share : Total profit divided by number of shares.
8. Depository Services: Transfer of securities by book entry without physical transfer.
9. AMBI : Association of Merchant Bankers of India.

8.11 Reference Books:

1. *Capital Market* : N. Gopalaswamy - Macmillan India Ltd. - The Indian Financial Scene.

2. *Financial Institutions and Markets* : L.M. Bhole - TaTa McGraw Hill Publishing Company Ltd., New Delhi.

- Dr. V.R. Jyostna Kumari

LESSON - 9

FACTORING SERVICES

9.0 Objectives:

This chapter discusses exhaustively the theoretical framework of Factoring Services including:

* Definition of Factor
* Salient features of Factoring Services
* Types and forms of Factoring
* Legal aspects of Factoring
* Advantages and evaluation of Factoring
* Factoring in India

Structure:

9.1 Introduction
9.2 Functions of a Factor
9.3 Types/Forms of Factoring
9.4 Legal Aspects of Factoring: Factoring Contract
9.5 Factoring Vs. Bills Discounting
9.6 Forfaiting
9.7 Factoring in India
9.8 Operational Problems
9.9 Summary
9.10 Key Words
9.11 Reference Books

Definition:

There is no inform codified low regarding the term factoring. The tern “factoring” has been defined in various countries in different ways. Many efforts have been made to arrive at a consensus regarding uniform meaning and defining a well laid scope for such a type of service contract. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended in general terms, the definition of factoring as under.

“Factoring means an arrangement between a factor and his client which includes atleast two of the following services to the provided by the factor.

(1).Finance, (2) Maintenance of accounts, (3) Collection of debts, (4) protection against credit risk.

Factoring can broadly be defined as an agreement in which recievables arising out of sale of goods/services are sold by a firm to the factor, as a result of which the title to the goods/services

represented by the said receivables passes on to the factor. Hence forth the factor becomes responsible for all credit control sales accounting, and debt collection from the buyer. In full service, factoring concept, if any of the debtors fails to pay the dues, as a result of his financial inability or insolvency the factor has to absorb the losses.

9.1 Introduction:

Business transactions both at the retail and wholesale levels take place partly on the basis of cash and partly on the basis of credit. The buyers normally do not have to make down payments on delivery of goods and services. The sellers extend credit to the buyers during this interval of time between the receipt of goods and payment of cash. The dues which arise during this process of credit sales are known as “trade receivables” from the point of view of sellers and “trade payables” from the point of view of buyers. Although the practice of extending credit enables sellers to increase sales, it has a cost also. Therefore the efforts of sellers are always to collect receivables as quickly as possible. In another words receivables management occupies a significant part of the time, efforts and cost of working capital management on the part of the sellers and a good receivables management consists in reducing the collection period to the minimum without adversely affecting the sales. The sellers may make their own internal arrangements to collect receivables or they may hand over this job to a specialised collection agency. Such an agency is known as factor in the business world. A factor is thus a financial institution which manages the collection of accounts receivables of the companies on their behalf and bears the credit risk associated with those accounts. In general, factoring means, selling with or without recourse, the receivables by the firm to a factor. By factoring the company relieves itself of the organisation, procedures and internal expenses of collecting its receivables.

9.2 Functions of a Factor:

Depending on the type/form of factoring, the main functions a factor can be classified into five categories.

1. Administration of Sales Ledger:

The factor maintains the clients sales ledgers. On transacting a sales deal, an invoice is sent by the client to the customer and a copy of the same is sent to the factor. The ledger is generally maintained under the open item method in which each receipt is matched against the specific invoice. The customer’s account clearly reflects the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables, receipts of payments from the customers and other useful information. In addition the factor also maintains a customer wise record of payments spread over a period of time, so that any change in the payment pattern can be easily identified.

2. Provision of collection facility:

The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection. So that the client can concentrate on other important functional areas of the business. The client can also reduce cost of collection by way of savings in manpower, time and efforts. Collection of receivables can be considered as the most important function of a factor.

3. Financing trade debts:

The unique feature of factoring is that a factor purchases the books debts of the company at a price. The debts would be assigned in favour of the factor. The factor grants advances to the extent of 80% of the assigned debts. In case the debts are factored with recourse, the finance provided by the factor would become refundable by the company in case of non-payment by the buyer. However, where the debts are factored without recourse, the factor's obligation to the seller becomes absolute on the due date of the invoice whether or not the buyer makes the payment.

4. Credit Control and Credit Protection:

Assumption of credit risk is one of the important functions of a factor. This service is provided where debts are factored without recourse. The factor inconsultation with the client fixes credit limits for approved customers. Within there limits, the factor undertakes to purchase all trade debts of the customer without recourse. In otherwards the factor assumes the risk of default in payment by customers. Arising from this function of the factor, there are two important incidental benefits accuring to the client. First factoring relieves the firm/client of the collection work; secondly with access to extensive information available on the financial standing and credit rating of individual customers and their track record of payments the factor is able to advise the client on the credit worthiness of potential customers leading to better credit control.

5. Advisory Services:

By virtue of their specialised knowledge and experience in finance and credit dealings and access to extensive credit information, factors can provide a variety of incidental advisory services to their clients.

6. Cost of Services:

The factors charge commission for collection and sales ledger administration and interest for advance part payment.

9.3 Types/Forms of Factoring:

Depending upon the features built into the factoring arrangement to cater to the varying needs of trade, clients, there can be different types of factoring. The collection of receivables and sales ledger administration is a common feature of practically all factoring transactions. Additional features are also included in some of these arrangements. The important forms of factoring arrangements are briefly discussed below:

1. Recourse and Non-recourse factoring:

Under recourse factoring arrangement, the factor has recourse to the client, if the debt purchased/receivable factored turns out to be irrecoverable. In otherwards the factor does not assume credit risks associated with the receivables. If the customer defaults in payment, the client has to make good, the loss incurred by the factor. The factor charges the client for maintaining the sales ledger and debt collection services and also for the interest for the period on the amount drawn by the client. The factor does not have the right of recourse in the case of non-recourse factoring. The loss

arriving out of irrecoverable receivables is borne by him, as a compensation for which he charges a higher commission. The additional fee charged by him as a premium for risk-bearing is referred to as a delcredere commission.

2. Advance and Maturity factoring:

The factor pays a prescribed portion ranging between 3/4 ths 9/10 ths of the factored receivables in advance. The balance being paid upon collection on the guaranteed payment date. A drawing limit as a prepayment is made available by the factor to the client as soon as the factored debts are approved/the invoices are accounted far. The client has to pay interest on the advance/ repayment between the date of such payment and the date of actual collection from the customers. An extension of advance factoring is bank participation factoring under which a bank provides an advance to the client to finance a part. The maturing factoring is also known as collection factoring. In this type, the payment is made either on the guaranteed payment date as on the date of collection.

3. Full factoring:

This is the most comprehensive form of factoring combining the features of almost all the factoring services specially those of non-recourse and advance factoring. It is also known as old line factoring. It provides all services like collection, credit protection, sales ledger administration and short term finance.

4. Disclosed and undisclosed factoring:

In disclosed factoring, the name of the factor is disclosed, in the invoice by the supplier or manufacturer of goods, asking the buyer to make payment to the factor. The supplier bears the risk of non-payment by the buyer without passing it on to the factor. The name of the factor is not disclosed in the invoice in undisclosed factoring, although the factor maintains the sales ledger of the manufacturer. The entire realisation of the business transaction is done in the name of the supplier's company, but all control remains with the factor. He also provides short-term finance against sales invoice.

5. Domestic and Export/Cross Border/International factoring:

In domestic factoring, three parties are involved, namely customer, company/client and factor. In export/cross border factoring, four parties are involved namely Exporter (client) importer (customer) Export factor and import factor. International factoring provides a non-recourse factoring deal. The clients have full protection against bad debt loss on credit approved sales. The factors take necessary assistance and avail facilities provided in the exporting country for export promotion. They handle exporter's overseas sales on credit terms. In fact, the factor becomes the sole debtor to the exporter once documentation is complete and goods have been shipped.

9.4 Legal Aspects of Factoring: Factoring contract:

Factoring contract in like any other sale-purchase agreement regulated under the law of contract. There is no codified legal frame work/code to regulate factoring services in India. The legal relationship between a factor and a client is largely determined by the terms of the factoring contract entered into before the factoring process starts. Some of the contents of the factoring agreement and legal obligations of the parties are as follows:

1. The client gives an undertaking to sell and the factor agrees to purchase receivables subject to the terms and conditions mentioned in the agreement.

2. The client warrants that receivables are valid, enforceable, undisputed and recoverable. He also undertakes to settle disputes, damages and deductions relating to the bills assigned to the factor.

3. The client agrees to serve notices of assignments in the prescribed form to all those customers, whose receivables have been factored. He provides copies of all invoices, credit notes etc relat ing to the factored accounts to the factor.

4. The factor acquires power of attorney to assign the debts further and to draw negotiable instruments in respect of such debts.

5. The legal status of a factor is that of assignee. The customer has the same defence against the factor as he would have against the client.

6. Before factoring a receivable, the factor will require a letter of disclaimer from the bank which has been financing the book debts through bank finance to the effect that from the date of the letter, the bank will not create a charge against the receivables.

7. The factor must make sure that the book debts it handles are free from any encumbrances which would entitle someone else to the money due. The firm will have to guarantee that the book debts are free from any rights of a third party in the factoring agreement.

8. The attractions of factoring for many companies is that non-recourse factoring can give a degree of insurance against the customer who does not pay. This will depend on whether the debt is approved or not which is decided before the factoring process starts.

9. Factoring agreements provide for payment by the customer directly to the factor. If any customer pay it to the client by mistake, the agreements provides that the firm must hold the money for the factor. If he does not do so, this is effectively a breach of trust and the firm may be held responsible for any losses incurred by the factor.

10. **Warrants:** Some warrants that will be required are the firm should disclose any material fact, that it knows night affect the factor's decision to approve a debt. It will have to warrant that the invoices sent for factoring represent a proper debt for goods supplied.

11. The factor may require the customer to notify it immediately in case of disputed debts.

12. The factor is power to inspect the firm's books and accounts and the period of factoring arrangement is usually laid down in the agreement.

13. Regarding assignment of book debts of clients, provisions of section 130 of the transfer of property act protect the interests of the factor.

9.5 Factoring Vs. Bills discounting:

Both factoring and Bills discounting provide short term finance. Both discount the accounts receivable which the company/client would have otherwise received from the Buyer at the end of the credit period.

But there are some differences between factoring and bill discounting. They are (1) Bill discounting is always with recourse. Whereas factoring can be either with recourse or without recourse.

2. In bill discounting the drawer i.e. the firm undertakes the responsibility of collecting the bills and remitting the proceeds to the financing agency where as in factoring, the factor takes the responsibility of collecting the bills.

3. Bill discounting provides only Finance. But factoring also provides other services like sales ledger maintainence and advisory services.

4. Discounted bills may be rediscounted several times before they mature for payment. Debts purchased for factoring can't be rediscounted, they can only be refinanced.

5. Factoring provides bulk finance against several unpaid trade generated invoices in batches. Bill financing is individual transaction oriented. Each bill is separately assessed and discounted.

6. Factoring is an off-balance made of financing. Bill discounting does not involve assignment of debts as is the care with factoring.

9.6 Forfaiting:

Forfaiting is a form of financing receivables pertaining, to international trade. It denotes the purchase of trade bills promissory notes by bank/financial institution without recourse to the seller. The purchase is in the form of discounting the documents covering the entire risk of non-payment in collection. All risks and collection problems are fully the responsibility of the purchaser who pays cash to seller after discounting the bills/notes.

Evaluation:

Factoring as a financial service has several positive features from the point of view of the firm. Some of the advantages of factoring are briefly discussed below:

1. Off-balance sheet finance:

Factoring provides off-balance sheet finance. The finance provided by the factor appear in the balance sheet only as a contingent liability in the case of recourse factoring. In the case of non-recourse factoring it does not appear anywhere in the financial statements of the borrower.

2. Reduction of current liabilities:

Factoring reduces the current liabilities of the firm. Factoring finance can be used for paying off other current liabilities comprising trade creditors for goods and services, creditors for expenses, loan installments payable and other statutory liabilities.

3. Improvement in current ratio:

As the factoring transaction is off the balance sheet, it removes from the assets side the

receivables factored to the extent of the pre-payment made and on the liabilities side, the current liabilities are also reduced.

4. Higher credit standing:

Factoring improves the firm's credit standing, with the increased finance by factoring, the firm is able to meet its liabilities promptly as and when they arise. The factor's acceptance of the firm's receivables itself speaks highly for the quality of the receivables. In the case of non-recourse factoring, the factor's assumption of credit risk relieves the firm to a significant extent from the problem of bad debts. This enables him to minimise his bad debts reserve.

5. Improved efficiency:

Small units face resource constraint for high level specialisation in credit control and sales ledger administration. Factoring is designed to place such units on the same level of efficiency in the areas of credit control and sales ledger administration as more sophisticated large companies.

6. More time for planning, production:

Any business concern has to allot some portion of its management time for credit control. Large firms can have special departments for this purpose. However small units cant offered it. The factor undertakes the responsibility for credit control, sales ledger administration and debt collection problems. Thus the firm can concentrate of the functional areas of the business like planning, purchase, production marketing and finance.

7. Reduction of cost and expenses:

Since the firm need not have a special administrative set up to look after credit control. It can have the benefit of reduced overheads by way of savings on manpower, time and efforts, with the steady and reliable cash flow faciliated by factoring, the clients can have many opportunities to cut costs and expenses like taking supplier's prompt payment and quantity discounts ordering for materials at the right time and at the right place, avoidance of disruption in the production schedule and so on.

8. Additional Source:

The supplier gets an additional source of finding the receivables which eliminates the uncertainty associated with the collection cycle. More importantly funds from a factor is an additional source of finance for the firm outside the par view of normal bank credit.

9.7 Factoring in India:

Factoring service is of recent origin in India. It comes its genises to the recommendations of Kalyana Sundaram Study group appointed by R.B.I. in 1989. Pursuant to the acceptance of there recommendations, the R.B.I. issued guidelines for factoring services in 1990. R.B.I. initially contemplated growth of factoring services on a Zonal/Regional basis covering the entire country with one/more banks concentrating in one zone at a time. It also preferred factoring services through subsidiaries of nationalised banks. More than one bank can jointly operate in a region forming a

subsidiary. The R.B.I. identified banks region wise to sponsor subsidiaries and provide factoring to clients in the specified regions. (1) State Bank of India for western region, (2) Canara Bank for the south zone, (3) Punjab National Bank for the northern region and (4) Allahabad Bank for the Eastern zone. However only the first two identified banks sponsored factoring services. Thus at present two factoring organisations exist in the country.

S.B.I. Factors and Commercial Services (SBI FACS):

It was floated promoted jointly by the State Bank of India, Union Bank of India and Small Industries Development Bank of India in March 1991 and commenced operations in April 1991.

Can Bank's factors Ltd.:

Jointly promoted by Canara Bank, Andhra Bank and SIDBI in August 1992, to operate in the south zone. In India domestic factoring and Export factoring are in operations. Export credit guarantee Corporation of India Ltd. provides a non-fund based export factoring service to the exporters who are ECGC policy holders.

The main source of finance of the factors in India at present are (1) equity capital and reserves, (2) line of credit from the sponsoring banks and SIDBI and public deposits.

9.8 Operational Problems:

The factoring service in India is at a mascent stage. Its growth is limited. There are so many operational obstacles in factoring in India.

1. Credit information:

The factors do not have access to any authentic common source of information. They have to depend on their own data-base for credit evaluation of clients. The system of multiple data-bases by individual factors is not only expensive but is also devoid of uniformity and obviously is a serious impediment in the growth of factoring service. The establishment of specialised credit information agency is urgently called for.

2.Stamp Duty:

The assignment of debt attracts stamp duty charged by the states which is high as 15% on the amount exceeding 2 lakhs. It inflates the cost of operations of service and erodes the profitability of the factors.

3. Legal framework:

Charges are also called for in other components of the present legal framework to ensure success of factoring in India.

4. Funding:

The factors in India are not allowed access to wider funding sources on scales available to other finance companies. Virtual dependence on equity funds does not permit them to have optimal

funding. For a cost effective financing of there companies greater access to the debt and money market like the learning and other finance companies is an urgent necessity.

5. Disclaimer certificate:

To purchase book debts of its clients, a factor needs a disclaimer certificate from banks. In the present context, they are reluctant to issue such a certificate. The factoring companies should be allowed to purchase book debts without requiring such a certificate from banks.

6. Limited Coverage:

At present, only domestic factoring of the advance with recourse is permitted and offered in India. Although ECGC and S.B.I. FACS have instituted measures for export factoring, no headway has been made. It is high time to provide export factoring to Indian exporters.

9.9 Summary:

Factoring means the sale of receivables (book debts) by a firm to a financial intermediary (factor) who pays when they are collected or in a guaranteed payment date. It basically involves transfer of collection of receivables and the related maintenance of records from the client to the factor. In essence factoring is a source of financing of receivables and facilitates the process of their collection.

The main functions of a factors are broadly divided into five categories, (1) collection of receivables, (2) financing of trade debts, (3) assumption of credit risk/control/protection, (4) maintenance of sales ledger and (5) provision of advisory services. For providing these services, the factors charge commission and interest for short term finance.

There are five types of factoring arrangements (1) Recourse and non-recourse factoring, (2) Advance and maturity factoring (3) Full factoring (4) Disclosed and undisclosed factoring (5) Domestic and export/cross border/International factoring. There is no codified legal framework to regulate factoring in India. The legal relationship between the factor and the client is governed by the provisions of the factoring contract. Domestic factoring as a fund based service differs from bills discounting and export factoring from forfaiting which finances deferred credit transactions related to exports.

Factoring offers several advantages to a client including (1) off-balance sheet financing (2) reduction in current liabilities (3) improvement in current ratio (4) higher credit standing (5) Improved effeciency (6) reductions of costs (7) additional sources and of funds soon. However it involves a cost in terms of fee and discount charge and evaluation of factoring should be done as a cost-benefit analysis before resorting to factoring.

Factoring is still in a nascent stage in India. In pursuance of the recommendation of the Kalyana Sundaram Committee 1988, Banking regulation Act was amended permitting subsidiaries of banks to start factoring companies in conformity with the R.B.I. guidelines, presently there are two factors operating in the country. Only advance recourse domestic factoring is being offered with respect to inland receivables providing for pre-payment upto 80% of the value of the receivables.

Factoring deals in India encounter serious abstracts which stand in the way of growth of such services. (1) Lack of specialised credit information agency/bureau, (2) Stamp duty on assignment of debt. (3) Legal problems, (4) Funding limitations, (5) limited coverage. For the rapid development of factoring services in India, there problems should be solved immediately.

9.10 Key words:

Accounts receivable	: Debts which arise in the process of credit sales.
Factor	: an agents who takes the responsibility of collecting the receivables.
Sales ledger	: a ledger where all credit sales are recorded.
Client	: A firm, a company which enters into a factoring agreement.
Forfaiting	: form of financing receivables pertaining to international trade.

9.11 Reference Books:

1. *Financial Services* : M.Y. Khan; TaTa McGraw Hill Publishing Company Ltd.

2. *Financial Institutions and Markets* : L.M. Bhole; TaTa McGraw Hill Publishing Company Ltd.

- Dr. V.R. Jyostna Kumari

LESSON - 10

COOPERATIVE BANKING

10.0 Objectives:

The author tries to give a vivid presentation about cooperative banking in India, to make students clearly understand.

* The features of Cooperative Banking
* The structure and development of Cooperative banking and the recent policy measures of Reserve Bank of India and NABARD.

It is felt that the students will get an exhaustive idea about cooperative banking in India.

Structure:

The chapter exhaustively explains the following:

10.1 Introduction

10.2 Meaning of Cooperative Banking

10.3 Structure of Cooperative Banking

10.4 Problems of Cooperative Banking

10.5 Co-operative Banks - Reserve Bank of India.

10.6 Co-operative Banks - NABARD

10.7 Summary

10.8 Technical Terms

10.9 Reference Books

10.1 Introduction:

Cooperation means voluntary association on the basis of equality and for some common purpose. The basic principle of cooperation is 'each for all and all for each'. In the words of H. Colvert "Cooperation is then a form of organisation wherein persons voluntarily associate together as human beings on the basis of equality for the promotion of their economic interest. The distinguishing features of a cooperative society are (1) Its membership is voluntary, (2) Its organisation is democratic, (3) Its functioning is based on decentralised division making principle, (4) Its aim is economic, social and moral development of its members. (5) It is non exploitative in character, (6) It combines the benefits of private ownership and public good.

10.2 Meaning of the Cooperative Bank:

Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. They are part of the vast and powerful superstructure of cooperative institutions which are engaged in the tasks of production, processing, marketing, distribution,

servicing and banking in India. The beginning of cooperative banking in this country dates back to about 1904 when official efforts were initiated to create a new type of institution based on the principles of cooperative organisation and management which were considered to be suitable for solving the problems peculiar to Indian conditions. In rural areas, institutional credit was inadequate and unorganised money market agencies such as money lenders were providing credit at high rates of interest. The cooperative banks were conceived in order to substitute such agencies, provide adequate short term and long term institutional credit at reasonable rates of interest and to bring about integration of the unorganised and organised segments of the Indian money market.

Expansion of the Structure:

Features: The features of Cooperative Banks are explained as under.

1. Organised on the basis of Cooperation:

Cooperative banks are organised on the principles of cooperation, self help and mutual help. They function with the rule of “one number one vote”.

2. No Profit, No Loss:

Cooperative banks function on ‘No Profit No Loss Basis’. Cooperative banks by their very mature do not pursue the goal of profit maximisation.

3. Perform main banking functions:

Cooperative banks perform all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities. Cooperative banks are organised by functional specialisation.

4. Agricultural and Rural Sector:

Cooperative banks do banking business mainly in the agricultural and rural sector. However certain types of Banks merely urban cooperative banks operate in semi-urban, urban, metropolitan areas also.

5. Government sponsored and supported financial agency:

Cooperative banks perhaps, the first government sponsored government supported and government subsidized financial agency in India. They get financial and other help from the R.B.I., NABARD. Central government and State Governments. They constitute the most favoured banking sector with no risk of nationalisation. For commercial banks, the RBI is the lender of the last resort, but for cooperative banks it is the lender of the first resort which provides financial resources in the form of contribution to the initial capital, working capital and refinance.

6. Federal in Structure:

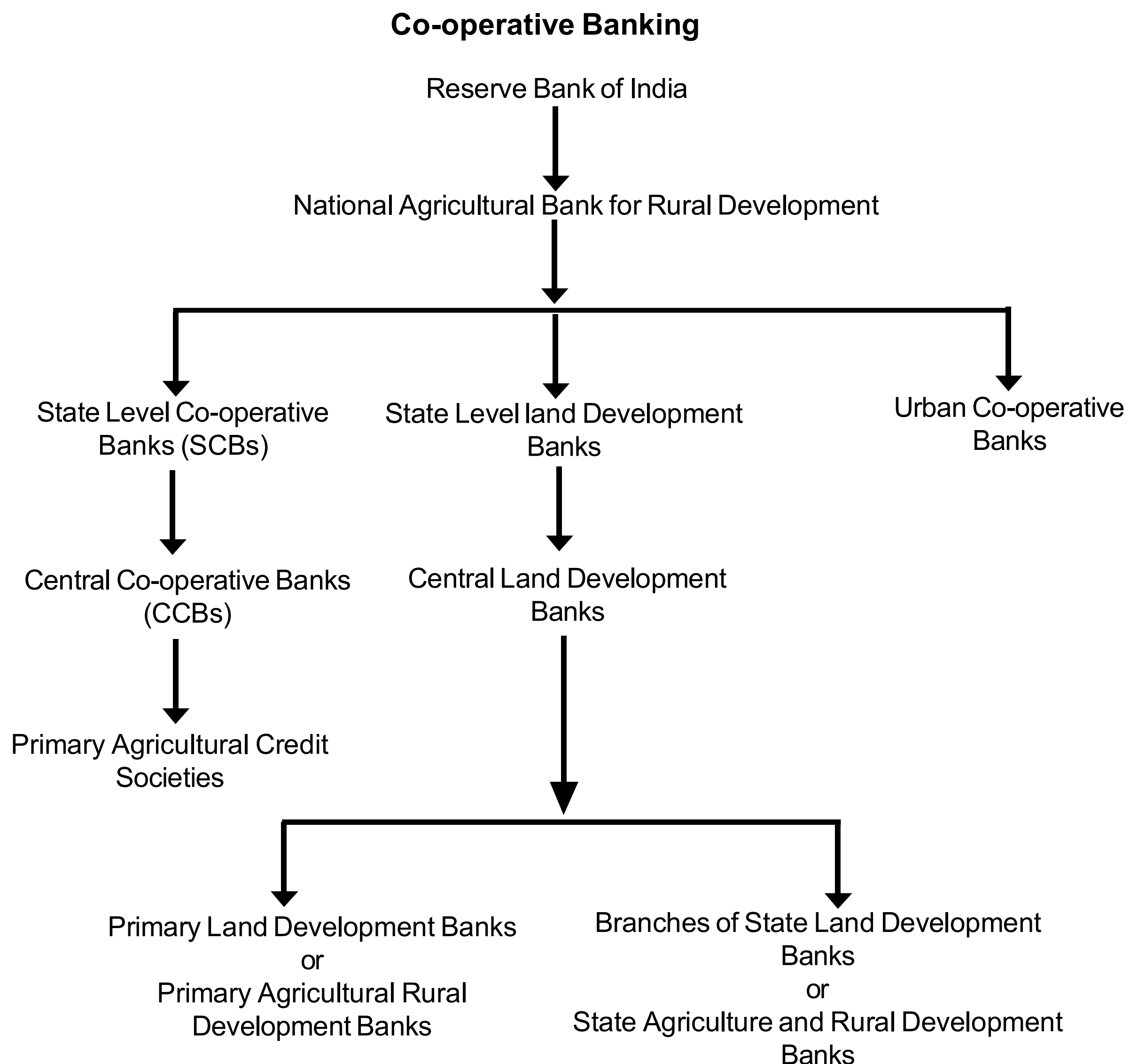
Cooperative banking in India is federal in structure. Primary credit societies are at the lowest level. Then there are central cooperative banks at the district level and state cooperative banks at the state level.

10.3 Structure of Cooperative Banks:

Cooperative banking structure is federal in character with three tier linkages between state, district and village level institutions. At the state level, we have state cooperative banks and the state land development banks. At the district level central cooperative banks or the district central cooperative banks and the central land development banks. Then at the village level, the primary agricultural credit societies, the primary land development banks and the branches of state land development banks. The lower tiers are members and shareholders of the immediate higher tier. Besides there are urban cooperative banks or the primary cooperative banks which are outside the federal structure. Though federal invites organisation structure, the system is integrated vertically on the basis of functional responsibilities of various components of the system. The state cooperative banks, central cooperative banks and primary agricultural credit societies form the short-term and medium term credit structure and it is the same in all the states. The land development banks at various levels make the long term credit structure which is not uniform in all the states.

The present structure of cooperative banking is depicted in the following chart.

Co-operative Banking



The state level cooperative banks are said to be the apex institutions in this federal structure. However the apex institutions from the point of view of promotion, supply of resources, supervision and control are the government, R.B.I. NABARD and National Cooperative Bank of India. State cooperative banks and state land development banks are in an intermediate position between R.B.I., Govt. and the cooperative banks.

The cooperative banks can be explained as under.

I. State Cooperative Banks:

State Cooperative banks are the apex institutions in the three tier cooperative credit structure operating at the state level. Every state has one state cooperative bank.

Functions: The state cooperative banks perform the following functions:

1. Coordinate the activities of primary agricultural credit societies and central cooperative banks in the state.
2. Arrange funds for the entire credit structure of the state.
3. Control the activities of central cooperative banks.
4. Act as an important link between the Indian Money market and the cooperative sector.
5. Help in maintaining a balance among the central cooperative banks by transferring funds from surplus central cooperative banks to deficit central cooperative banks within a state.
6. In case there is no central cooperative bank in a district, it provides credit facilities direct to primary agricultural credit societies in that district.
7. Function as a commercial bank.

Management:

A state cooperative bank is managed by a general body which holds its meeting once a year. It is formed by the representatives of PACs, CCBs and individuals. It is governed by a Board of Directors whose number varies between 10 to 30, which also appoints the staff.

Funds:

The working capital of a state cooperative bank consists of (1) the share capital which it gets by selling its share to PACs, CCBs and individuals, (2) Reserve fund which comprises 25% of its profits, Deposits from members and non-members and borrowings from the Reserve Bank of India, state government commercial banks and inter bank borrowings.

Loans:

The state cooperative banks lend to CCBs for short term to meet the needs of PACs. They do not lend direct to PACs except in those cases where there is no CCB in a district. Loans are given on the basis of promissory note.

II. Central Cooperative Banks:

The central cooperative banks are in the middle of the three tier cooperative structure. The CCBs are federations of Primary Agricultural Credit Societies in a particular district. So they are also known as District Central Cooperative Banks. They are of two types, one whose membership is confined to PACs. This type is known as banking union and such banking unions exist in Kerala, Orissa, Punjab, Haryana and Rajasthan. Two those having mixed membership, consisting of both PACs and individuals. Such banks exist in the majority states in India.

Functions:

The CCBs perform the following functions:

1. They give credit to PACs without any security.
2. They also give credit to individual customers on the security of gold etc.
3. They foster the habit of thrift and saving among their clients by accepting deposits and paying higher rate of interest than commercial banks.
4. They also provide remittance facilities to their customers.
5. They help in solving the problems of PACs.
6. They also control and supervise the working of PACs especially where the recovery of loans is slow.
7. They help in maintaining a balance among the PACs under their jurisdiction by transferring funds from a surplus society to a deficit society.
8. They help in the proper utilisation of the reserve fund of PACs lying with them.

Management:

The CCBs are managed by a Board of Directors who are elected on the principle of one member one vote. Its members vary between 10 and 20. The board appoints trained staff like manager, accountant etc for the proper functioning of the bank.

Funds:

The working capital of central cooperative banks consist of (1) share capital which they get by selling their shares to individuals and PACs under their jurisdiction (2) Reserve fund of PACs and owned funds (3) Deposits of members and non-members (4) Borrowings from the state cooperative bank, commercial banks and the state government and (5) Deposits of local bodies and even of educational institutions.

Loans:

Central cooperative banks give loans to their PACs to meet their financial needs. Short term loans are provided for agricultural operations for a period not exceeding 12 months. The medium term loans are given for the purchase of cattle, for installing pumps and for the repair of wells or sinking of well for a period ranging from 1 to 5 years. Loans are given to societies on their promissory notes.

III. Primary Agricultural Credit Societies (PACs):

Primary Agricultural Credit Societies also known as Agricultural Cooperative Societies, are meant to develop the spirit of mutual help and cooperation among their members besides meeting their credit and other needs. The features of a primary agricultural credit society are as follows:

1. PACs forms the base in the three tier cooperative credit structure.
2. It is a village level institution which directly deals with the rural people. It serves as the last link between the ultimate borrowers i.e. the rural people on the one hand and the higher agencies i.e. central cooperative bank, state cooperative bank and the reserve bank of India on the other hand.
3. A primary agricultural credit society may be started with 10 or more persons of a village. The membership fee is nominal so that even the poorest agriculturist can become a member.
4. The liability of members is unlimited. That is each member undertakes full responsibility for the entire loss of the society in case of its failure.

Objectives :

PACs are formed,

1. To provide short term PACs are formed and Medium term credit.
2. To foster the habit of saving
3. To distribute fertilisers and seeds
4. To provide help in milk production, egg production, sugar production, or any other product depending upon the resources of the area and
5. To distribute consumer goods to their members.

Management:

The management of PACs is on democratic lines. Each member has the right to cast only one vote irrespective of the number of shares held by him. All the members form the general body which in turn elects the managing committee annually. It consists of the president or chairman, secretary and members. Except the secretary who is paid some remuneration, all others work in an honorary capacity.

Funds:

The working funds of PACs consists of share capital membership fee, reserve fund (which is 25% of profits) deposits of members and non members and loans from the central cooperative banks. They also accept grants gifts and charities.

Loans:

The PACs grant short term loans for meeting productive and unproductive needs of only their members. The medium term loans are granted upto a certain limit and in special cases, loans are

given against personal security and security of land or crop. The rate of interest charged is lower than the rate in the organised money market. Loans are repayable in installments.

Land Development Banks:

Land development banks were earlier known as land Mortgage banks are meant to meet the long term credit needs of agriculturists. Their structure is not uniform in the country. It is unitary in some states, and in some others it is federal and in Himachala Pradesh and West Bangal, it is both unitary and federal. Under the federal structure, there is the central land development bank at the state level and the primary land development banks (PLDBs) at the district level. The central land development banks lend to agriculturists through PLDBs. They are known as State Cooperative Agricultural and Rural Development Banks (SCARDBs).

Features:

1. The Land Development Banks are registered as cooperative societies. Their liability is limited.

2. These banks have two tier structure. At the state level, there are state or central development banks, generally one for each state. At the local level, there are branches of the state land development banks and the primary land development banks. In some states, there are no primary land development banks but the branches of the state land development bank. In Madhya Pradesh, the state cooperative bank itself functions as state land development bank. In other states like A.P., Kerala and Maharastra, there are more than one state land development banks.

3. The primary land development banks are vary organisationally in different states. At the National level the land development banks have also formed a union, called All-India Land Development Bank's union.

Management:

The Land development banks are registered under the cooperative societies Act. LDB is managed by a Board of Directors consisting of 15 to 20 members duly elected by numbers by primary land development banks and nominated members by the state government and registrar of cooperative societies.

Funds:

The LDBs raise funds by share capital contributed by borrowing and non-borrowing members. Deposits from public issue of debentures. LDBs issue three types of debentures (1) Ordinary debentures by individuals and institutions (2) Rural Debentures issued to farmers at the time of harvesting for 7 and 15 years, (3) Special development debentures issued for land development improvement which are purchased by NABARD, concerned state government and the central government.

Functions:

Land Development Banks provide long-term loans to agriculturists for a period ranging from 5 to 25 years for the following purposes.

1. To make improvements on the land

2. To repay old debts

3. To free the mortgaged hand

4. To buy new land.

In recent years they have also started lending for non agricultural purposes, such as to the rural cottage industries and small enterprises in rural areas.

Loans:

The LDBs give loans to their members on the security of their lands which are generally limited to 50% of the value of land mortgaged.

Trends and progress of cooperative banks:

Cooperative banks, with their extensive branch network and localised operational base, play a key role in the development process in general and credit delivery and deposit mobilisation in particular. Different segments of the cooperative banking sector address specific credit needs of diverse sections of the population, both in terms of location as well as tenor. The progress and development of cooperative banking can be explained as under.

State Cooperative Banks:

The state cooperative banks are the apex of the cooperative credit structure in each state. The state cooperative bank finances and controls the working of the central cooperative banks in the state. It is a link between NABARD and the central cooperative banks and the village primary agricultural credit societies. At present there are 30 state cooperative banks in our country. The position and development of state cooperative banks is shown in the under given table.

Table - I

Position of State Cooperative Banks

(Rs. in crores)

Year	No. of offices of SCBs	Loans and advances	Outstanding loans & advances
1950-51	568	6260.61	4101.60
1960-61	586	7729.53	5061.95
1970-71	631	8711.72	6145.12
1990-91	662	11572.61	7518.64
1995-96	717	22398.64	10926.86
1997-98	790	24150.9	13706.71
1999-2000	831	25709	4212.44
2000-2001	847	29848	5074.16
2001-2002	847	32111	6111.09

Source: Recent trends in Indian Banking - C.M. Chowdary, subline Publications, Jaipur Pg. No.63 "Report on trend and progress of Banking in India" R.B.I. 2001-02, 02-03.

The above table reveals that the branches of SCB's have increased, while the number of SCBs has increased from 16 in 1951 to 30 in 2000-2001. The loans and advances have increased by six times during the period 1950-51 to 2000-01. The recovery performance of SCBs is low. It declined from 84% in 2000-01 to 81% in 2001-02. In some states like Haryana, Madhya Pradesh, Tamilnadu, Karnataka, Kerala, Punjab, Chattisgarh and Gujarat, SCBs achieved more than 90% recovery. During the year 2001-02, out of 30 SCBs 23 have made profits aggregating to Rs.270 crores, while 7 made lows amounting to Rs.93 crores. The percentage of NPAs to loans outstanding is 13.4% in SCBs during 2002.

Progress and Development of Central Cooperative Banks:

Central cooperative banks are the federations of primary credit societies in specified areas covering the whole district. They are the intermediaries between central cooperative banks and state cooperative banks. NABARD has formulated a scheme for the rehabilitation of week central cooperative banks. NABARD is providing liberal assistance to the state government for contributing to the share capital of the Weak Central Cooperative Banks. The progress of central cooperative banks is depicted in the following table.

Table - 2

Position of Central Cooperative Banks

Year	No. of CCBs	Loans & Advances	Outstanding loans & Advances
1950-51	505	-----	83
1960-61	390	-----	350
1970-71	341	-----	894
1990-91	351	-----	18,377
1995-96	361	22,373	18,240
1998-99	361	34,911	24,639
2000-2001	367	45,016	52,478
2001-2002	368	59,269	----

Source: Recent trends in Indian Banking-C.M. Chowdary subline publications, Jaipur- page No.62. "Report on trend and progress of Banking in India" R.B.I., 2001-02, 2002-2003.

The above table reveals that the number of CCBs has declined because of amalgamation. The amount of loans and advances has been increasing, but the amount of outstanding loans and advances has also been increasing, but the amount of outstanding loans and advances has also been increasing, due to poor recovery. The recovery performance of CCBs as a proportion of demand declined from 70% in 1999-2000 to 67% in 2000-01. The recovery percentage is also same in 2001-02. During 2001-02, 258 CCBs made profits amounting to Rs.698 crore, while 110 CCBs made losses to the tune of Rs.719 crore. The deterioration in the overall profitability of CCBs could be attributed to higher expenses for provisions and contingencies.

Progress Primary Agricultural Credit Societies (PACs):

Primary Agricultural Credit Societies (PACs) the gross root level arm of short-term cooperative credit mediate directly with individual borrowers, grant short to medium term loans and

also undertake distribution and marketing functions. The Development of PACs is presented in the following table.

Table - 3

Position of PACs at the National Level

(Rs. in Crores)

Year	No. of Societies (000)	Loans & Advances (Rs. in Crores)	Over Dues (Rs. in Crores)
1950-51	106	23	6
1960-61	212	202	40
1970-71	161	578	784
1987-88	92	3730	5150
1990-91	88	4834	3295
1994-95	90	9373	11404
1999-2000	92	13600	--------
2000-2001	100	13481	34522
2001-2002	98.25		

Source: Recent trends in Indian Banking; C.M. Chowdary, Subline publications; Jaipur, Page No.61 "Report on trend and progress of Banking, R.B.I. 2001-02, 2002-03.

There are 98,247 PACs as on March 31, 2002 with about 10 crore members. A large number of PACs however face severe financial problems primarily due to significant erosion of own funds, deposits and low recovery rates.

Urban Cooperative Banks (UCBs):

Urban Cooperative Banks are registered under the cooperative societies Acts of the respective state governments. UCBs having a multi-state presence are registered under the Multi-state cooperative societies act and regulated by the central government. Besides, the R.B.I. also has regulatory and supervisory authority for bank related operations under certain provisions of the Banking regulation Act, 1949. UCBs are included in the second schedule of the R.B.I. Act, 1934, provided their net demand and time liabilities are atleast 100 crore and subject to certain other related criteria.

The number of UCBs is 2,104 at the end of March 2003, which included 89 salary earners banks and 133 Mahila banks of there 163 banks were under liquidation as at the end of March 2003. As at the end March 2002, 1,817 UCBs achieved the stipulated target of allocating 60% of their total advances to priority sector and 1,407 banks accomplished the required level of 15% of total advances to weaker sections in the priority sector. The UCBs are facing serious problem with NPAs. As at the end of 2003, the non-performing assets of banks are 21% of their aggregate advances.

Land Development Banks:

Land Development banks are formed to provide long-term investment credit. At the state level, state land development banks or state cooperative agricultural and rural development banks and at the primary level, primary cooperative agricultural and rural development banks or the branches of land development banks were established to facilitate augmentation of capital formation in agriculture.

Table
Position of Primary Land Development Banks or Primary Agriculture and Rural Development Banks

Year	No. of PLDBs	Membership	Loans & Advance (Rs. in crores)	Outstanding Loans (Rs.in crores)
92-93	726	6,503	435	1,463
93-94	727	7,221	664	1,527
94-95	731	7,360	705	1,699
96-97	765	7,565	785	1,736
97-98	835	8,650	850	1,865
98-99	745	---	1,735	6,778
99-2000	755	---	1,819	7,611
2000-2001	732	---	1,865	8,352
2001-2002	739	---	1,933	8,960

Source: Recent trends in Indian Banking. C.M. Chowdary, Subline Publications, Jaipur; Pg.no.64, Report on trend and progress of Banking in India, R.B.I., 2001, 2002.

The number of PLDBs decreased in recent years as shown by the above table, due to liquidation and mergers. The loans issued by PCDBs are increasing, at the same time over dues are also increasing. The recovery performance of PLDBs is 53% in 2002. During 2000-01, there were 284 profit making and 448 loss making PLDBs, and in aggregate they registered a loss of Rs.158 crore.

State Land Development Banks:

State Land Development Banks or State Cooperative Agricultural and Rural Development banks constitute the upper tier of long-term cooperative credit structure in India. The Development of State land Development banks can be shown in the following table.

Table

Position of State Land Development Banks (SLDBs)

Year	No. of SLDBs	Membership	Loans & Advances (in crores)	Outstanding Loans (in crores)
1992-93	19	65	1,231	4,719
1993-94	20	80	1,352	5,405
1994-95	20	112	1,540	5,646

1996-97	20	170	1,711	5,809
1997-98	20	191	2,112	6,415
1998-99	20	215	2,317	6,865
1999-2000	19	-----	2,532	11,565
2000-2001	20	-----	2,586	12,596
2001-2002	20	-----	2,693	14,000

Source: Recent trends in Indian Banking - C.M. Chowdary, Subline publications; Pg no.65
Report on trend and progress of banking in India 2001-02, 2003

As shown by the above table, the loans advanced by SLDBs are increasing. At the same time, outstanding loans are also increasing. The recovery performance is 62% in 99-2000, 58% in 2000-01 and further reduced to 58% in 2001-02. During 2000-01. 17 SLDBs reported profits, whereas 7 incurred losses. In aggregate SLDBs incurred a loss of 126 crores during the year.

10.4 Problems of Cooperative Banks:

The cooperative banks having extensive networks, with reach in remote areas, play a significant role in the Indian economy, especially in creating banking habits among the lower and middle income groups and in rural credit delivery. This sector with uneven geographical spread and detailed stratification has substantial heterogeneity in both financial position and performance within and across different strata. While many cooperative banks are healthy and conduct their business efficiently, some others are facing various problems. The problems of cooperative banks can be explained as under.

I. Poor Loan recovery - high level of non performing assets:

The major problem, the cooperative banks are facing is non performing assets due to poor loan recovery. Among credit cooperatives, the proportion of gross NPAs as a percent of loans outstanding is relatively higher for the lower tier institutions. As on 31st March 2001, gross N.PAs of SCBs stood at Rs.3,889 crore accounting to 13 percent of their outstanding loans and advances. In regard to CCBs, gross N.P.A.s were at Rs.9,371 crore which equivalent to 17.9% of their outstanding loans and advances. In respect to PLDBs and SLDBs, the percent is more. It is 20.4% and 23.9% respectively.

II. Erosion of Capital:

Another grave problem, the cooperative banks are facing is erosion of capital. Depletion of assets has eroded not only own funds, but also affected deposits to the time of Rs.1,934 crores by the end 2002. Deposits in respect of one SCB and 14 CCBs had been fully eroded while for 1 SCB and 26 CCBs the erosion has been to the extent of 50% and above.

III. Increasing Losses:

Majority of the cooperative banks are incurring losses. There losses are raising due to increasing provisions and contingencies. Out of 368 CCBs 245 made profits, and 113 incurred losses. This situation is more critical in case of PACs and PLDBs. During 2000-2001, 284 PLDBs made profits, while 448 incurred losses, amounting to 158 crore. A large number of PACs are facing severe financial problems primarily due to significant erosion of capital, deposits and low recovery rates.

IV. Duality/multiplicity of control:

Duality, multiplicity of control comes in the way of effective regulation and supervision of cooperative banks. The major issue in this context is the overlapping jurisdiction of the state governments and the R.B.I. Successive committees have recommended that there should be clear demarcation of areas of regulatory responsibilities between the state governments and the R.B.I.

V. Regional disparities:

There have been large regional disparities in the distribution of cooperative credit. Eight states of Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharastra, Punjab and Rajasthan account for about 80% of the total credit disbursed. The spread of urban cooperative banks also is not uniform throughout the country. By the end of March 2003, there are 2,104 VCBs in India. Out of them 169 in A.P., 362 in Gujarat, 324 in Karnataka and 670 in Maharashtra are found. The rest of the banks are concentrated in other states. This clearly defects regional disparities in cooperative credit.

VI. Lack of Professionalism in Management:

Cooperative banks are not managed by professionals. They are facing so many administrative problems. There is no proper audit of cooperative banks.

VII. Poverty of funds:

Cooperative banks are facing severe financial problems especially PACs. They are relying more on Borrowings. Due to poor recovery, there is significant erosion of own funds and deposits. Due to severe financial problems, they are not able to compete effectively with commercial Banks.

10.5 Cooperative Banks - Reserve Bank of India:

Strengthening the cooperative credit movement has been the R.B.I.'s special responsibility ever since its establishment in 1935. The following are the various measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country.

I. Agriculture Credit Department:

The R.B.I. has a separate Agriculture credit department whose functions are

(1) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the central and state governments, state cooperative banks and other banking organisations.

(2) To coordinate the operations of the Reserve bank in connection with agricultural credit and relations with the state cooperative banks and other institutions engaged in the business of agricultural credit.

II. All India Rural Credit Survey:

The R.B.I.s real role in the cooperative credit movement started with the appointment of All India Rural Credit Survey committee in 1951. The objective of this committee was to study the problems of rural credit and explore possibilities of expanding agricultural credit through cooperative

credit system. The committee submitted its report in 1954 which highlighted the vital importance of cooperative rural credit. The committee found that while private credit agencies i.e. money lenders, and traders supply 70% of the rural credit, the cooperative societies provided only 3% of the total borrowed amount. The committee observed that the rural credit in India felt short of the right quantity, was not of right type, did not serve the right purpose and often fail to go the right people.

III. Integrated Scheme of Rural Credit:

For the success of cooperative credit movement, the survey committee suggested an integrated scheme of rural credit based on the following fundamental principles. (a) State Partnership in cooperative credit institutions, (b) Full coordination between credit and other agricultural activities, particularly marketing and processing and (c) administration through adequately trained and efficient personnel responsive to the needs of the rural population.

IV. Provision of Finance:

In pursuance of the recommendations of the survey committee and other committees, R.B.I. actively helping the cooperative credit system by providing short-time, medium and long term finance.

V. National Cooperative Development Corporation (NCDC):

Set up in 1962-63, plays a promotional and Development role in stengthening and developing agriculture and allied activities in the cooperative sector, acts as a buffer between cooperatives, the states, and the central government.

Reforms in the Cooperative Sector:

1. A Multi State Cooperative Society called National Cooperative Bank of India was set up in August 1993.

2. Lending and deposit rates of all cooperative banks, excluding PCBs were deregulated in October 1994, subject to an minimum lending rate of 12%.

3. Scheduled PCBs were allowed in April 1996, to undertake equipment learning and hire purchase financing activities after meeting certain prudential requirements. The prudential accounting norms were made applicable to state cooperative banks/central cooperative banks from the year 1996-97 in two phases, 1996-97 and 1997-98.

4. As a part of reform process, the government enacted the demutualization of cooperatives act. Financial incentives were given to banks that converted their ownership into a limited company structure. A small number of banks were able to demutualization and follow through with an issue public offer, some cooperative banks were forced to close down while others were taken over by more efficient banks.

10.6 Cooperative Banks - NABARD:

The National Bank for Agriculture and Rural Development (NABARD) was established in July 1982, to take over and decentralise the R.B.I's functions in the sphere of rural credit. It was set up for providing credit for the promotion of agriculture, small scale industries hand crafts, cottage and village industries, handcrafts and other rural crafts and other allied economic activities in rural

areas. The committee to review arrangement for institutional credit for agriculture and rural development (1981) recommended that the new bank take over from the Reserve bank the overseeing of the entire rural credit system and the statutory inspection of cooperative banks and Regional rural banks on an agency basis, the Bank continues to retain its essential controls.

On its establishment NABARD has taken over from the R.B.I. its refinancing function in relation to state cooperative banks and the regional rural banks. The Bank is the coordinating agency in relation to the central government, planning commission, state governments, and institutions at all India and state levels engaged in giving effect to the various policies and programmes relating to rural credit.

Refinance:

NABARD provides refinance assistance for long-term loans for 25 years to state land development banks (now known as state cooperative agricultural and rural development banks), scheduled commercial banks, RRBs and state cooperative banks.

During 2001-02, NABARD granted Rs.7,319 crore loans to state cooperative banks for short term and Rs.854 crore for medium term loans. The loans raised to Rs.7358 and 493 crore respectively during 2002-03.

An Expert Committee on Rural Credit by Prof. V.S. Vyas constituted by NABARD submitted its report on August 2001. In pursuance of the recommendations, NABARD has initiated action one some of the related areas, such as financing assets-less poor, small formers, tenants etc.

The capoor committee set up by the government to study the cooperative credit structure had suggested various measures for strengthening and revitalising the cooperative credit structure in its report submitted in July 2000. An inter-Ministerial joint committee under the chairmanship of Shri Balasehabvikhepatil reviewed the recommendations, particularly those relating to the funding mechanism and sharing pattern of revitalisation assistance amongst the government of India states and cooperatives. Based on these recommendations NABARD placed its scheme before the government in October 2002. The scheme which envisaged linking of revilatisation assistance to cooperative banks to certain reforms to be carried out by the state government included the following measures.

(1) Adoption of essential features of Model Cooperative Societies Act, particularly removal of duality of control by state governments and R.B.I.

(2) Autonomy to cooperative credit institutions.

(3) Audit of SCBs/DCCBs/SCARDBs by chartered accountants and freedom to PACs for this purpose.

(4) Professionalisation of Management

(5) Adoption of transparent HRD Policies.

(6) Abolition of common cadre system of PACs secretaries.

10.7 Summary:

The basic principle of cooperation in “one for all and all for one” the cooperative societies act

was passed in 1904. Cooperatives started with great speed from the first five year plan in our country. It was considered an instrument of planned economic action in democracy. The cooperative credit has been recognised as better suited for agriculture credit than the state for ensuring proper utilisation of credit for productive uses. The structure of cooperative credit is broadly divided into two (1) short and Medium term ad long term, State cooperative banks at the state level. Central cooperative banks at the district level and primary credit societies at the village level provide short term and medium term credit. Primary land development banks also known as primary agricultural and rural development banks at the district level and state land development banks or state agricultural and rural development banks provide long term credit. At the village level primary credit societies may be started with ten or more persons. As on 31-March-2003, there are 98,247 PACs at national level with about 10 crore members. A large number of PACs are facing severe financial problems primarily due to erosion of funds, deposits and low recovery rates. Central cooperative banks are the federations of primary credit societies in specified areas covering the whole districts. As on 31st March 2003, there are 368 DCCBs at national level. The state cooperative banks are the apex institutions. At present there are 30 SCBs in our country. There are 739 primary land development banks as on 31st March 2003, and 20 state land development banks. Though cooperative banks with extensive networks, play a key role in Indian economy are suffering from various problems, like erosion of capital, mounting overdues, increasing losses resulting in liquidation, poverty of funds etc. To remove there problems and strength cooperative banks, R.B.I. and government are taking so many measures.

10.8 Technical Terms:

PLDBs : Primary Land Development Banks at present known as Primary Cooperative Agriculture and Rural Development Banks.

SLDBS : State Land Development Banks at present known as Primary Cooperative Agriculture and Rural Development Banks.

Apex institution : Key or link institution.

NPA (Non performing Asset) : If the income or principal remain overdue for 180 days and is being replaced by 90 days norm.

Prudential norms: relate to assets classification

10.9 Reference Books:

1. *Banking Theory and Practice* - K.C. Sekhar, Vikas Publishing Pvt. Ltd.

2. *Money, Banking, and International Trade* - M.L. Jhingan; Konark Publications.

3. *Recent trends in Indian Banking* - C.M. Chowdary; Subline Publications

4. *Indian Financial System* - H.R. Machiraju, Vikas Publishing House Pvt. Ltd.

5. Report on trend and progress of Banking in India 2001-2002, R.B.I.

6. Report on trend and progress of Banking in India 2002-2003, R.B.I.

- Dr. V.R. Jyotsna Kumari

Lesson 11

Indigenous bankers and Moneylenders

11.0 Objectives:

The main purpose of this lesson is to help you to:

- — Understand the role played by indigenous bankers and moneylenders
- — Study the defects in the working of indigenous bankers and declining importance
- — Know the features of moneylenders
- — Study the defects in the working of moneylenders and declining importance

Structure:

11.1 Introduction

11.2 Meaning and nature of indigenous bankers

  11.2.1 Operations of indigenous bankers

  11.2.2 Sources of indigenous bankers

  11.2.3 Lending by indigenous bankers

  11.2.4 Customers of indigenous bankers

11.3 Defects in working of indigenous bankers

11.4 Declining importance of indigenous bankers

11.5 Meaning and operations of moneylenders

  11.5.1 Types of money lenders

  11.5.2 Operations of money lenders

11.6 Distinction between moneylenders and indigenous bankers

11.7 Defects in working of moneylenders

11.8 Declining importance of moneylenders

11.9 Summary

11.10 Key Words

11.11 Self-Assessment Questions

11.12 Suggested Readings

11.1 Introduction:

India is an agricultural country and above 70% of people lives in villages and depends on agriculture. They need finance for developing land, purchase of seeds, fertilizers, feeding stuff etc. Therefore, they go for financial support from local moneylenders first. Similarly, industrialists, small and medium industrial owners often approach indigenous bankers for financial support. In this background, let us discuss on these areas here.

11.2 Meaning and nature of indigenous bankers:

According to the Indian Central Banking Enquiry Committee, an indigenous banker or bank is an individual or a private firm receiving deposits and dealing in hundis or lending money. According to the Committee, those who donot accept deposits are not indigenous bankers. However, the Madras provincial Banking Enquiry Committee opined that receiving deposits could not be treated as the sole distinguishing feature of indigenous bankers. According to Bengal Provincial Banking Enquiry Committee, " indigenous bankers are individuals or firms who deal in hundis, whether they accept deposits or not". Many treat this as a better definition.

Indigenous bankers occupy a unique position in the credit structure of India. Only certain communities are popular doing this business. They may be grouped as Multanis, Marwaris, Bengalees, Gujaratis, Chettis and Kalladakurichi Brahmins. Of these, the Multanis and Marwaris operate mainly in Mumbai, Kolkata and Rajasthan. The Gujaratis and Bengalees do their business in Kolkata, where as the Chettis and Kalladakurichi Brahmins run their operations in Tralmilnadu. Shikarpuris of Sind and Bohras or Rehitis of Gujarat are also come under this category. Most of the indigenous bankers have offices and branches in several important commercial centers of the country.

11.2.1 Operations of indigenous bankers:

Indigenous bankers mainly involved in banking and trade businesses. The Multani bankers deal only in banking business. The Gujaratis on the other hand, deal mainly in trade and do banking business only if they have surplus funds. The Marwaris and Bengalees do both banking and trade businesses. Banking is their main business. These bankers do not usually maintain separate accounts for the different branches and they do not have separate establishments for their banking business.

Primarily, indigenous banking in India is an unorganized sector. However, some of them are organized into guilds, which discuss matters of common interest, settle disputes among their constituents and act as insolvency courts. There is also coordination among the various classes of bankers and some of them are bound together by ties of caste and religion. In a few centers they have organized themselves into associations like Bombay Shroffs' Association, Association of Shroffs, Kolkata etc.

Indigenous bankers in general are not highly educated. They receive practical training in their own firms and acquire experience. They do not have any fixed working hours. They maintain personal touch with their customers. They maintain personal touch with their customers. They know the background of all their borrowers aand watch carefully their financial position. They know the family history of the people in the locality and understand whom to advance and to what extent. Their accounting and business methods are simple and are in practice for a longer period.

Even in the present developed stage of banking business, indigenous bankers still occupy recognizable position in the Indian financial arena. They are playing significant role through providing working capital and long-term capital needs of industrial units. They also subscribe to the debentures floated by industrial enterprises. In some areas, they are also making deposits with industrial enterprises, which constitute a substantial portion of working capital of the latter.

11.2.2 Sources to indigenous bankers:

The indigenous bankers receive deposits from the public and pay interest on them. The rate of interest depends upon the amount of interest, the condition of the market and the personal relations with the depositors. Primarily, they depend on their own capital. In case of necessity indigenous bankers supplement their resources borrowing from commercial banks either on demand promissory notes or by discounting hundis endorsed by them.

11.2.3 Lending by indigenous bankers:

Usually indigenous bankers lend money on promissory notes or on receipts signed by the borrowers acknowledging the loans and mentioning the agreed rate of interest. The rate of interest varies depending on the security offered. They also lend money against bonds on stamped legal forms mentioning conditions of repayment. For example, the borrower has to pay higher rate of interest if he fails to pay the amount before the agreed date. Indigenous bankers lend money on mortgage of houses, land and other immovable properties.

Indigenous bankers also lend by drawing and discounting of hundis. These hundis may be either 'darshani' or 'muddati' hunids, i.e., demand or usance bills. These are also 'dhanijog' hundis which are payable only to the payee, 'shahjog' hundis which are payable to any respectable merchant of shroff, 'dekhandar' hundis which are payable only to orders. The hundis may be purely trade bills or finance bills or accommodation bills.

11.2.4 Customers of indigenous bankers:

The customers of indigenous bankers generally consist of the ryots, small industrialists and traders. They normally finance ryots through local moneylenders and deal directly with others.

11.3 Defects in the working of indigenous bankers:

The following are the various defects in the indigenous banking system.

1. High rate of interest: Indigenous bankers charge very high rates of interest. They range from 25 to 100 percent or even more. On mortgages, they charge below 24 percent. These high rages of interests discourages people to approach indigenous bankers
2. Low deposit formation: Indigenous bankers accept deposits at a lower level. Because, they depend mostly on their own funds for their business. Hence, it can be said that they are not playing significant role in deposit mobilization or capital formation.
3. Defective operations and management: Indigenous bankers do both banking and trading business simultaneously and do not maintain separate accounts. Further, they do not publish annual accounts and they do not get their accounts audited. They maintain secrecy in the business, which causes suspicion in the minds of public.
4. Discouraging bill market: Bill market is an important component of a developed money market. Indigenous bankers discourage the creation of a bill market. Most of their finance is to trade and that too in the form of cash.
5. Outside RBI control: Indigenous bankers do not want to come under the control of Reserve Bank of India. For effective control of money of market, all parts of effluent

parts of money market should be under RBI control. Thus, indigenous bankers are hampering the fluidity in the money market.

6. Wrong purpose of loans: Most of the indigenous bankers new credit goes either for paying interest or paying of old debts. Only 5 percent of the credit is going for good cause like improving land, buying seeds and fertilizers etc.

11.4 Declining importance of Indigenous bankers:

Because of the following reasons the importance of indigenous bankers came down drastically in the recent past.

1. In the recent past banking sector developed in leaps and bounds. But indigenous bankers have not changed their methods or procedures, which make them still backward.
2. The joint stock banks and other organized segments have drastically improved their competitiveness and are progressing rapidly.
3. The growth and development of cooperative banking system and awareness of cooperative principles among the rural masses pushed indigenous bankers to the background.
4. Indigenous bankers themselves want to leave their banking business and settle in attractive fields of trade and commerce as the economy of the country is speedily progressing.
5. Good services of modern banks with minimum remittance facilities reduced the importance of moneylenders to the lowest.
6. Political awareness among the rural masses also affected the indigenous bankers adversely.
7. Indigenous bankers are attracted towards speculation business leaving behind their banking business.
8. Indigenous bankers do not get statutory protection like other banks.
9. The present regulatory and supervisory system relating to non-banking financial companies also made the indigenous bankers stop growing.

11.5 Meaning and operations of Moneylenders:

Moneylenders and indigenous bankers do almost similar type of business. The main difference between these two categories is that unlike indigenous bankers, moneylenders do not deal with hundis. They carry their operations mainly in rural areas.

Moneylenders lend money to the local people to support their immediate necessities. They also charge higher rates of interest like indigenous bankers. Moneylenders and indigenous bankers have similarities in several aspects, they are both unorganized, both are scattered and both are adapted to different traditions, habits, customs and needs of the people.

11.5.1 Types of moneylenders:

Moneylenders can be broadly divided into professional and non-professional. Professional moneylenders may again be resident and itinerant. The ‘Mahajans’ or ‘sowcars’ come under resident moneylender category. The ‘pathans’ come under itinerant moneylender category. The

non-professional moneylenders do not take up lending business as a profession, nut as and when they have surplus funds they utilize them through lending. Landowners, big agriculturists, merchants and traders pensioners etc., come under this category. The distinction between professional and non-professional moneylenders loses its validity as many States have passed moneylenders' Acts and put some restrictions. Now, any person who wants to be in money lending business has to acquire license from the government concerned.

11.5.2 Operations of moneylenders:

Generally moneylenders lend money to the people on personal security and without any written agreement. However, when the amount is large, they ask for promissory notes. Unlike the case of indigenous bankers the clients or customers of moneylenders are prompt in their repayments as they maintain close contact with their lenders. Sometimes, moneylenders lend money not only to the local or village people, they also lend to the neighboring villages or town to whom they have no personal contact. To cover the risk moneylenders, in such cases, charge higher rates of interest. Moneylenders generally fix time of repayment fall immediately after harvest. However, they may consider sympathetically to the borrowers in case of crop failure, natural calamities etc., and sometimes they may give additional loan to agriculturists for survival. Many a times, moneylenders make advances to agriculturists against the security of crops. After harvest, agriculturists have to sell the crop proceeds to the moneylenders generally at the lower prices.

11.6 Distinction between moneylenders and indigenous bankers:

The following are the differences between moneylenders and indigenous bankers.

Moneylenders	Indigenous bankers
1. Moneylenders do not deal with hundis.	1. Indigenous bankers deal with hundis.
2. They do not accept deposits.	2. They accept deposits from the public.
3. They finance generally for agriculturists and other rural masses.	3. They finance for trade and industry.
4. They charge higher rates of interest.	4. When compared to moneylenders, they charge lower rates of interest.
5. Moneylenders do not insist for security	5. They insist on security for their advances.

11.7 Defects in working of moneylenders:

Some opine that moneylenders are good to cultivators; they help in times of trouble. However, many have criticized moneylenders as land grabbers, helpers of factions and lawsuits, bloodsuckers etc. All India Rural Credit Survey Committee observed that moneylenders couldn't be given any place in the field of institutional financing agencies. Let us see various defects in working of moneylenders.

1. Moneylenders charge exorbitant rates of interest ranging from 75 to 300 percent.

2. Moneylenders often exploit the illiterate rural masses. In many cases, they obtain thumb impression of the illiterate borrower with the object of entering any arbitrary figure later on.
3. They take out conditional sale deeds of borrowers properties and handover them in case of failure or delay in repayments.
4. Moneylenders when they advance on crops, they force the cultivators to sell the proceeds to them at lower prices.
5. As the resources of moneylenders are inadequate, they cannot finance sufficiently to the agriculturists.

11.8 Decline of moneylenders:

Because of various reasons mentioned below, moneylenders are declining at a faster speed. One, many moneylenders advance to illiterate rural masses taking their thumb impressions and later adopt to malpractice like change of figures, dates, properties etc. This makes them unpopular and their consequent decline. Two, growth of cooperative credit societies, cooperative banks and availability of cheaper credit facilities make the rural people almost forget almost the existence of moneylenders. Three, spread of education, growing consciousness among rural masses, and growth of self-help groups also produced similar result. Four, because of various Acts and resultant rules in different States and compulsory licensing made some of the moneylenders to leave this business.

11.9 Summary:

Even in the present advanced banking business scenario indigenous bankers and moneylenders have not completely lose their validity. Indigenous bankers are playing considerable role in hundis business and in financing for trade and industry. However, there are some defects in the working of indigenous bankers. Moneylenders are primarily rural based and financing mainly agriculturists. They charge higher rates of interest and exploit the illiterate borrowers in different ways. There are several defects in working of moneylenders and they caused for their decline.

11.10 Key words:

Indigenous bankers —— Individuals or firms who deal in hundis irrespective of accepting deposits.

Moneylenders — Lend money to rural masses and do not deal with hundis.

11.11 Self-Assessment Questions:

Short Questions:

1. Who is an indigenous banker?
2. How many types of moneylenders are there?
3. Why moneylenders are declining?

Small Questions:

1. Explain the reasons for declining importance of indigenous bankers.
2. Distinguish between moneylenders and indigenous bankers.
3. What are the defects in working of moneylenders?

Essay Questions:

1. Define an indigenous banker. Explaining the operations of indigenous bankers, bring out the defects in the working of indigenous bankers.
2. Who is a moneylender? Why money lending business declined in India in the recent past?

11.12 Suggested Readings:

1. Banking theory and Practice——— K.C. Shekhar and Lekshmy Shekhar
2. Banking theory and Practice——— P.K Srivastava

Dr. R. Jaya Prakash Reddy

Lesson 12

Foreign Banks

12.0 Objectives:

The main purpose of this lesson is to help you to:

- Understand the concept and importance of foreign banks in India
- Study the present status of various foreign banks
- Know the recent acquisitions and mergers of foreign banks
- Study some complaints against foreign banks
- Learn the role of foreign banks in financing priority sector

Structure:

12.1 Introduction
12.2 Present status of foreign banks in India
12.3 Mergers and acquisitions
12.4 Financing of foreign trade
12.5 Complaints against foreign banks
12.6 Foreign banks and priority sector lending
12.7 Summary
12.8 Key Words
12.9 Self-Assessment Questions
12.10 Suggested Readings

12.1 Introduction:

Foreign banks in India are playing significant role in financing foreign trade and in lending to priority sector. Here in this lesson we study in detail about foreign banks and their role.

A bank is a foreign bank if its origin and head office located outside India. Earlier foreign banks were known as 'exchange banks'. Operation of foreign banks in India is not a new thing. Even before 20th century certain foreign banks were doing business in India. At one time they influenced Indian money market to a great extent. They have also contributed significantly for the development of Indian joint stock banks.

12.2 Present Status of Foreign Banks in India

If any foreign bank wants to establish its branches in India, it has to invest a minimum capital of US $ 25 million spread over three branches, i.e., US $ 10 million for the first branch, additional US$ 10 million for the second branch and further US$ 5 million for the third branch. Additional branches may be permitted after monitoring performance of existing branches, their financial results, inspection findings etc. As per the agreement under World Trade Organization, a foreign bank has to acquire 12 licenses per year for new and also for expansion of existing banks. They have to acquire licenses even of off-site ATMs.

Government of India, after receiving requests from foreign banks may permit them to start their operations in India keeping in view the financial soundness of the bank, international and home country ranking, rating, international presence and economic and political relations between the two countries. The home country of the bank should not discriminate against Indian banks. The bank should be under the control and supervision of the home country.

As on September 2002, there were 40 foreign banks operating in India with 203 branches. While 4 banks has 10 or more branches each, 18 banks were operating with only one branch each. The branches of foreign banks were spread over 25 centres in 15 States/Union Territories. Foreign banks had also set up representative offices in India. As on June 30, 2002, 23 banks from 12 countries had representative offices in India, of which 19 were in Mumbai, three in New Delhi and one in Chennai. Thus, 63 banks had presence in India either through branches or representative offices. Over time, foreign banks have increased the share of their deposits and outstanding credit. As on March 31, 2002. These banks had aggregate deposits of Rs.64, 510 crore and an outstanding bank credit of Rs. 48,632 crore.

The existing foreign banks details along with their working performance can be known through studying their size and strength (deposits, average working funds, net profit and growth in profit after tax), operations (net interest income, cost of average interest bearing funds and free income), productivity and efficiency (operating profit per employees/ per branch, cost to income and return on capital employed), quality of earnings (operating profits and return of average assets), capital adequacy and quality of assets (net advances, non-performing assets growth and loan loss). As it is a lengthy exercise, for easy understanding, their capital adequacy ratios are considered. The following table shows the capital adequacy ratios of 40 foreign banks for the years 1997-98, 1999-2000, 2001-02 and 2004-05.

Capital Adequacy ratios of foreign banks from 1997-98 to 2004-05

Sl.No	Name of the Bank	1997-98	1999-2000	2001-02	2004-05
1	ABN-AMRO Bank N.V	9.82	10.09	13.17	10.55
2	Abu Dhabi Commercial Bank Ltd.	10.29	10.61	10.42	14.38
3	American Express Bank Ltd.	9.86	10.09	10.71	10.87
4	Arab Bangladesh Bank Ltd.	144	123	138.51	109.39
5	Bank International Indonesia	28.03	59.92	123.07	92.26
6	Bank Muscat S.A.O.G	N.A	70.06	28.33	N.A
7	Bank of America N.A	8.95	12.93	21.07	30.07
8	Bank of Bahrain and Kuwait B.S.C	10.48	12.3	17.03	11.66
9	Bank of Ceylon	40.05	29.07	30.94	49.4
10	Barclays Bank P.L.C	14.52	17.75	63.56	20.85
11	BNP Paribas	8.8	9.55	9.66	9.41
12	China trust Commercial Bank	146.33	25.56	40.11	59.94
13	Chohung Bank46	38	27.75	55.31	
14	Citibank N.A	8.61	10.62	11.04	10.78
15	Commerzbank AG	12.81	17.58	171.54	N.A

16 Credit Agricole Indosuez	8.41	11.82	11.23	N.A
17 Credit Lyonnais	8.7	9.7	10.3	14.4
18 Deutssche Bank AG	9.69	10.68	14.55	16.22
19 Development Bank of Singapore Ltd.	31.47	18.14	13.31	N.A
20 Dresdner Bank AG	16.89	18.69	39	N.A
21 HSBC Ltd.	9.82	10.3	10.92	14.03
22 ING Bank N.V	12.91	21.15	12.47	9.09
23 JPMorgan Chase Bank (The Chase Manhattan Bank)	13.03	45.86	85.88	10.19
24 K.B.C.Bank N.V	N.A	18.51	96.75	N.A
25 Krung Thai Bank Public Co. Ltd.	347.22	197.74	167.65	101.01
26 Mashreqbank psc	29.84	9.04	20.54	60.14
27 Mizuho Corporate Bank Ltd (The Fuji Bank Ltd.)	43.45	15.29	11.14	28.76
28 Oman International Bank S.A.O.G	13.38	11.08	18.86	13.52
29 Oversea-Chinese Banking Corporation Ltd.	90.93	98.34	192.12	N.A
30 Societe Generale	10.74	13.95	12.85	64.81
31 Sonali Bank	27.8	24.91	113.64	105.81
32 Standard Chartered Bank	9.3	9.5	9.28	10.46
33 Standard Chartered Grindlays Bank Ltd.	9.05	10.93	13.08	N.A
34 State Bank of Mauritius	N.A	N.A	N.A	31.06
35 Sumitomo Mitsui Banking Corporation ** (The Sumitomo Bank Ltd.)	40.67	18.54	20.96	N.A
36 The Bank of Nova Scotia	10.3	9.67	15.27	
37 The Bank of Tokyo-Mitsubishi Ltd.	8.73	17.62	15.36	32.1
38 The Siam Commercial Bank	30	30.06	-13.33	N.A
39 The Toronto-Domonion Bank Ltd.	86.61	51.98	173.28	N.A
40 UFJ Bank Ltd. (The Sanwa Bank Ltd.)	30.35	36.17	29.44	121.6

Sources: 1. Banking Theory and Practice — K.C.Sekhar & Lekshmy Shekhar, Vikas Publishing House Pvt. Ltd., 19th Edition, 2005, pp: 330 & 331.

2. Business Today, Feb, 26,2006, pp: 102-111.

* Merged with Credit Agricole to form Calyon Bank

** Standard Chartered Bank acquired Sumitomo Mitsui Bank's Indian operations.

N.A : Not Available

From the above table it can be said that the capital adequacy ratio of foreign banks by and large is satisfactory. In other words, all the foreign banks working in India are in healthy financial condition.

12.3 Mergers and Acquisitions:

Mergers and acquisitions became common now a day. To avoid competition, to enter the new market or country, to strengthen the financial position etc., are the main reasons for mergers and acquisitions. Banks are not exception to this. In the recent past, in India several banks have merged and some banks have acquired needy and weak banks. Similarly, in foreign banks too, the following mergers and acquisitions took place in the recent past.

1. Morgan Guaranty Trust Company of New York merged with Chase Manhattan Bank and the new entity Viz., JPMorgan Chase Bank came into existence on November 11, 2001. It has one branch in Mumbai.
2. Sanwa Bank Ltd. And Tokai Bank Ltd. Merged globally and the Indian operations of both the banks (Sanwa Bank with one branch and Tokai Bank with a representative office) stood merged with effect from January 15, 2002. The new entity viz., UFJ Bank Ltd. Is operating with one branch in New Delhi.
3. Fuji Bank Ltd., which has a branch in Mumbai, has been renamed as Mizuho Corporate Bank Ltd. Consequent upon the merger of the bank with Dai-Ichi Kangyo Bank Ltd. And Industrial Bank of Japan on April 1, 2002.
4. Standard Chartered Bank acquired Sumitomo Mitsui Bank's Indian operations.
5. Credit Lyonnais merged with credit Agricole and formed Calyon Bank.
6. ING Group by increasing its stake in Vysya Bank closed its operations in India.

12.4 Financing of Foreign Trade:

Generally, a foreign bank establishes its branch in other country mainly to finance foreign trade. Similarly, all the foreign banks in India have started their operations with this view. But later they gradually entered the field of internal trade and started competing with Indian banks in attracting deposits of all kinds, discounting bills of exchange and making advances to trade and industry. However, their main purpose of financing of foreign trade continues.

Foreign banks are enjoying monopoly in financing foreign trade because of the following reasons:

1. Up to 1934 the Imperial Bank of India (present State Bank of India) was not allowed to transact foreign exchange business.
2. Other Indian Commercial banks though they have no restrictions, could not compete with foreign banks in financing foreign trade.
3. According to Central Banking Enquiry Committee the reasons for the backwardness of the Indian banks are as follows:

    a) Vast amount of capital resources, enormous goodwill and prestige of foreign banks in the world financial market.

b) Absence of Indian banks in foreign countries, lack of information about foreign exchange business and lack of experienced employees.

c) Higher returns of Indian banks in internal finance than foreign finance.

However, now the situation is changing slowly. The Indian banks are actively participating in the financing of foreign trade of the country.

12.5 Complaints against foreign banks:

In financing foreign trade foreign banks are no doubt playing dominant role. However, there are certain complaints against their working. They are as follows:

1. According to Indian banks, foreign banks enter into unfair competition and try to monopolize foreign trade. Large capital and head offices at world's important financial centers help the foreign banks in this regard.
2. Besides foreign trade, foreign banks are establishing their branches in the interior of the country and widening their operations into the field of internal trade.
3. Foreign banks are deploying their resources in large business houses, monopoly companies and multinationals where they can earn high rates of interest. This is against the philosophy of social banking. However, to avoid this trend, foreign banks are brought on par with Indian banks putting limit on their finance based on capital funds.
4. Indian clients are also complaining against foreign banks for the differential treatment of financing the export trade by D/A (Documents on Acceptance) and the import trade by D/P (Documents on Payment) bills. Foreign banks require satisfactory references and confidential reports from their traveling agents.
5. Another complaint against foreign banks is that they frequently insist that the business should be given to foreign shipping companies, insurance companies etc., before giving accommodation to India firms.

12.6 Foreign banks and Priority Sector Lending:

Foreign banks operating in India should lend 32 per cent of their net credit to priority sector. As foreign banks have no rural credit, their priority sector advances include export credit provided by them. Within the overall target of 32 per cent to be achieved by foreign banks, the advances to small-scale industries sector should not be less than 10 per cent of the net bank credit and the export credit should not be less than 12 per cent of the net bank credit.

In the event of failure on the part of foreign banks to achieve on the sub-targets or both the sub-targets and also the overall target of 32 per cent, the short fall in achieving the targets should be made good by placing with SIDBI (Small Industry Development Bank of India) a deposit of an equivalent amount. These deposits are treated as indirect finance to small-scale industries.

12.7 Summary:

The role of foreign banks in India is significant. 40 foreign banks are operating in India with 203 branches. 23 banks from 12 countries have representative offices in India. As on March 31,

2002, these banks aggregate deposits were Rs.64, 510 crore. All the foreign banks are working soundly. Their capital adequacy ratios for the past few years are satisfactory. Several mergers and acquisitions are taking place with foreign banks in India. The major activity of foreign banks is financing of foreign trade. There are certain complaints against foreign banks on certain issues. Foreign banks in India need to finance priority sector to the extent of 32 per cent if there is any deficit in the targets, to that extent they have to deposit at SIDBI as indirect finance to small-scale industries.

12.8 Key words:

Foreign bank —— A bank in India with its head office in a foreign country.

Merger —— Birth of a new bank with the resultant mix of two or more banks.

Acquisition —— Acquiring the needy or weak bank by a strong and sound bank.

Capital adequacy ratio —— The capital-to-risk weighted assets ratio.

12.9 Self-Assessment Questions:

Very short questions:

1. Do foreign banks lend to priority sector in India?
2. What are Mergers and Acquisitions mean?

Short questions:

1. Write a short note on recent Mergers and Acquisitions in foreign banks.
2. Why foreign banks are enjoying monopoly in India in financing foreign trade?
3. What are the complaints against foreign banks?

Essay question:

1. Write an essay on the role of foreign banks in India and in foreign trade.

12.10 Suggested Readings:

1. Banking Theory and Practice— K.C.Shekhar and Lekshmy Shekhar
2. Banking Theory and Practice— P.K. Srivastava

Dr. R. Jaya Prakash Reddy

Lesson – 13

BANKER AND CUSTOMER

13.0 OBJECTIVES

After completing this lesson you should be able to understand.

* the concept of banker and customer, as defined by enactments and views of experts.
* the duration theory and reasons for its rejection.
* the main and subsidiary services of a banker.
* the conditions required to constitute a customer.

Structure

13.1 Introduction

13.2 Origin

13.3 Definition of Banker

13.3.1 Definition of Hart

13.3.2 Definition of Sir John Paget

13.3.3 Definition of Banking Regulation Act

13.4 Definition of Customer

13.4.1 Views of Paget

13.4.2 Duration Theory

13.5 Summary

13.6 Self – Assessment Questions.

13.7 Essay Questions

13.8 References

13.1 INTRODUCTION

Banks have become a part and parcel of our life in the present days. Before the on set of Financial Sector Reforms, only people in towns and cities could enjoy their services. But, due to the process of Liberation, Privatisation and Globalisation banks have been offering a variety of services even to a common man. Moreever to fulfill the objectives of Nationalisation, the banks have come out from their traditional functions of late. Thus, they have been accelerating the economy of our country by catering to the needs of trade, industry, agriculture etc. This naturally creates interest in knowing more about the banks.

13.2 ORIGIN

There is no universally accepted view regarding the origin of the word 'bank'. The word Bank is said to have derived from the French word Banco or Banque which means a bench. It is believed that the early Jews in Lombardy conducted their business transactions by sitting on benches. When their business failed, their benches were broken and thus the word bankrupt came into use. But, Macleod has expressed a different view. According to him, the money changers were never called 'Benchieri' in the Middle ages.

Another view is that the word 'bank' is originated from the German word 'Back', which means a joint stock fund. In due course, it is Italianised into banco and Frenchised into bank and finally Anglicised into Bank. This view is most popular.

13.3 DEFINITION OF BANKER

A few definitions touching the essence of banking are given below:

13.3.1 Hart's Definition

Dr. H.L. Hart's defines a banker as, "One, who in the ordinary course of business honours cheques drawn upon him by persons from and for whom he receives money on current accounts".

This definition is based on a number of legal decisions in England. The two basic features according to this definition are:

(a) the receipt of deposits and

(b) honoring of cheques drawn by persons who have deposited money in current account with the banker.

13.3.2 Sir John Paget's definitions

According to him, "A bank or banker is a corporation or person or a group of persons who accept money on current accounts, pay cheques drawn upon such account, on demand and collect cheques for customers: that if such minimum services are afforded to all and sundry with out restriction of any kind, the business is a banking business whether or not, other businesses undertaken at the same time".

The basic features according to this definition are:

(a) take deposit account

(b) take current account

(c) issue and pay cheques drawn on himself

(d) collect cheques for his customers

13.3.3 Banking Regulation Act's definition

According to Banking Regulation Act of 1949, 'banking' means accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft order or otherwise.

The basic features according to this definition are:

(a) accepting of deposits for lending

(b) repayable on demand

(c) withdrawable by cheques etc

From the above definitions, it is clear that the essential feature of a banker is that he must accept deposits from the public withdrawable by cheques. The banker uses the deposits for the purpose of lending or investment. Borrowing and lending money should be main function of a banker.

A person who lends money from his own resources cannot be called as a banker. He can only be a money lender. However, in India law does not prohibit a money lender calling himself as a banker. In fact they are 'self styled bankers'.

13.4 DEFINITION OF A CUSTOMER

The term 'customer' is not defined statutorily either in India or in England. Generally, a person who has an account in a bank is considered as a customer. But there are certain differences of opinion in this regard. Old banking experts used to lay emphasis on the duration for which a person maintained account with the bank. They are of the opinion that mere opening of an account is not sufficient to constitute a customer of a bank. Importance is given to the period for which an account is maintained with the bank.

Thus, to understand the term 'customer', we have to rely on the legal decisions and the view's of the experts.

13.4.1 Sir John Paget

According to him, "to constitute a customer there must be some recognisable course of habit of dealing in the nature of regular banking business. He further adds it is difficult to reconcile the idea of a single transaction with that of a customer.

Thus, according to the above, definition to be a customer of a bank, the following editions must be satisfied:

(a) there must be some recognisable course or habits or dealing between him and the banker and

(b) the dealings must be of banking nature.

13.4.2 Duration Theory

John Paget gives importance to the duration of dealings between the banker and the customer. So, this theory is called as 'duration theory'. According to him, mere opening of an account in the bank does not constitute a customer. The same opinion was expressed in the case of Mathews Vs William Brown & Co. In the above case, it was decided that a single transaction does not constitute a customer. In other words to constitute a customer there must be continuity in dealings with the bank.

However, the opinion of Paget was rejected in the case of Lad broke Vs Todd. In this case, it was held that the relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection. Later, it was observed in many cases that a person becomes a customer as soon as he opens either a savings account or a current account. The habit of dealing with the bank may develop in future.

According to **Dr. Hart,** "A customer is one who has an account with a banker or for whom a banker habitually undertakes as such".

The above view was not accepted in case of Central Bank of India Ltd. Vs V. Gopinath Nair and others and also in the case of Commissioner of Taxation Vs English Scottish and Australian Bank Ltd.

In respect of Fixed Deposit Holder, there is difference of opinion ie., whether a fixed deposit holder can be considered as a customer or not. Some are of the opinion that a fixed deposit holder is not a customer as the banker do not make proper enquiry about such a depositor. The banker do not insist for his introduction by the existing customer as is done in the case of opening of other account holders. But according to the above observations a fixes deposit holder satisfies the conditions of opening an account and his depositing of money is also in banking nature.

From above, it is clear that to constitute a customer, the following conditions must be satisfied.

(a) He should have an account with the bank. The account may relate to fixed, current or savings.

(b) The dealings should be of banking nature. The dealings should be distinguished from dealings of casual nature.

(c) There should be atleast a single transaction.

(d) Frequency of transactions should not be insisted but can be anticipated.

The customer a bank need not be a person. It can be a Firm, Joint-stock, a Society etc. It also includes a Government Department and a Corporation incorporated under any law.

13.5 SUMMARY

There is no statutory definition either in India and in England for a banker and a customer. According to Paget, to constitute a customer there must be habit of dealings which are banking in nature. The duration theory was rejected in the case of Lad broke Vs Todd. It is the common opinion of all the experts that there must be regular banking business. A person who has no account with the bank does not constitute a customer but a single transaction constitute a customer in anticipation of further dealings with bank.

13.6 SELF – ASSESSMENT QUESTIONS

Definition of Banke

Definition of Customer

Duration Theory

Banking Regulation Act, 1949.

13.7 ESSAY QUESTIONS

(1) Define the term bank or banker with special reference to India?

(2) What do you mean by the term bank or banking?

(3) Define the term customer. Explain what constitutes a customer?

13.8 REFERENCES

* Indian Banking – Nature and Problems – Desai & Vasant
* Banking Law and Practice – Kalkundarikar & others
* Banking and Financial Systems – Mithani & Gordon

Dr. D. N. M. RAJU

Lesson – 13A

GENERAL FEATURES OF RELATIONSHIP BETWEEN BANKER AND CUSTOMER

13A.0 OBJECTIVES

By the time you complete this lesson, you should be able to understand:

* the debtor – creditor relationship between banker and customer.
* subsidiary functions of the banker.

Structure

13A.1 Introduction

13A.2 General Relationship

- **13A.2.1 Depository Relationship**
- **13A.2.2 Bailee Relationship**
- **13A.2.3 Trustee Relationship**
- **13A.2.4 Agent Relationship**
- **13A.2.5 Debtor – Creditor Relationship**

13A.3 Banker – a Privileged Debtor

13A.4 Summary

13A.5 Self – Assessment Questions

13A.6 Essay Questions

13A.7 Suggested Readings

13A.1 INTRODUCTION

The banker – customer relationship commences as soon as an account is opened at a bank. The relationship between the banker and the customer arises out of the contract between them. It is not imposed by law. This contractual relationship is regulated by the rules contained in the Negotiable Instruments Act and the Indian Contract Act. The relationship between the banker and the customer is of two kinds. They are

General Relationship and Special Relationship.

13A.2 GENERAL RELATIONSHIP

The General Relationship can be of the following:

Depository Relationship : Bailee Relationship;

Trustee Relationship : Agent Relationship; and

Debtor – Creditor Relationship

13A.2.1 Depository Relationship

A contractual relationship is created as soon as an account is opened with a banker by a person. A depository is one who receives some valuables and returns the same on demand. But, a banker is not bound to return the same coins and currency notes deposited by a depository. The banker can not run the business of lending if the customer insists for the return of the some coins and currency notes deposited. Further, the banker can not make use of the money received as deposit to his best advantage to make maximum profit. The entire profit earned on deposit is not returned to the customer. Only a part of it is returned as interest to the customer.

In the case of the **Foley V Hill,** it is observed that the money paid into bank ceases to be the money of the depositor ie., the principal. It becomes the money of the banker immediately. He can deal with it according to his own interest. He is bound to return an equivalent amount to the customer on demand.

13A.2.2 Bailee Relationship

A banker acts as a bailee in certain circumstances. He acts as a bailee when he receives valuables and gold ornaments for safe-custody. In this case, he cannot make use of them to his best advantage as he has to return the same articles on demand. Moreover, a banker can not acquire any title in respect of stolen articles. A banker will not pay any interest on these articles. In addition to this, the customer has to pay some amount as rent for the lockers.

So, a banker acts as a bailee when he receives articles for safe-custody but not when he receives money on deposit account.

13A.2.3 Trustee Relationship

According to **Prof. Keeton** a trust is, “a relationship which arises whenever a person called trustee is compelled in equity to hold property whether real or personal by equitable title for the benefit of some person”.

If a banker is regarded as a trustee, he can not make use of the money deposited by a customer to his best advantage. He will be bound by the trust deed. He has to render an account for everything he does with the trust money. It is because of this that a banker will not become a trustee when he opens an account of his customs.

But, a banker becomes a trustee under certain circumstances. For example, when money is deposited for a specific purpose, the banker becomes a trustee as long as that money is under trust. In the following circumstances the bankers acts as a trustee.

In the case of official assignee of Madras V. J.W. Irwin, a certain amount was deposited with the bank with a specific direction to purchase shares. The banker failed to do so. It was held that the banker was a trustee for that part of the amount which was meant for shares.

Similarly, where a cheque is given for collection, he holds the cheque as a trustee till the proceeds are collected. But the proceeds collected can not be held in trust. However, the bank can borrow the proceeds and repay them on demand.

13A.2.4 Agent Relationship

The banker acts as an Agent under certain circumstances. The Agent – Principal relationship exists between banker and customer when the banker buys and sells shares, collects cheques, bills, dividend warrants, pays insurance premia etc on behalf of customers. He also acts as an Executor when he executes the will of the customer. He also acts as a Administrator when he administers the estate of a customer. This type of relationship does not exist when he receives deposits from a customer.

13A.2.5 Debtor – Creditor Relationship

The main relationship between banker and customer is that of a debtor and a creditor. It depends on the state of affairs of the account of the customer. When the customer has a credit balance, there exists a debtor – creditor relationship. The banker being the debtor, has to reply the amount as and when the customer demands for it. On the other hand, when there is over draft, the relationship is reversed. In this case, the banker becomes the credit or and the customer is the debtor.

13A.3 BANKER – AS A PRIVILEGED DEBTOR

A banker as a debtor is not the same as that of an ordinary commercial debtor. In the case of ordinary commercial debt, the duty of the debtor is to find out the creditor and repay the money. But, in the case of banker's debt, the money is not repaid until a demand is made for repayment. Thus, a banker as a debtor enjoys certain privileges. They are:

(a) Creditor seeking out the Debtor

The customer must come to the banker and make demand for payment in writing. This is observed in the decided case of Joachinson Vs Swiss Banking Corporation. But, for this privilege, the banker will have to go to the doors of his customers and find out whether they are in need of money or not which is detrimental to the business of banking.

(b) Importance of place

In the case of commercial debt, the debtor can repay money to the creditor at any place. Out in the case of banker's debt, the creditor must make demand in writing for repayment. The demand for payment must be made at the branch where the account is kept. The above opinion was expressed in the case of Clare & Co. Vs Dresdneu Bank.

(c) Importance of Time

Time is not an essential element in case of commercial debt. In the case of banker's debt the

demand for repayment must be made on a working day and during the working hours.

In the case of Arab Bank Vs Barclays Bank, it was held that a banker is liable to honour the cheques if presented during the business hours.

(d) Without Security

In the case of banker's debt, the banker do not offer any security. In other words, the customer is unsecured whereas in case of ordinary debt it is not so. It is a privilege to the banker to get deposits without security.

(e) Application of Law of Limitation Act

In the case of commercial debt, it becomes time barred after the expiry of three years from the date of loan. But the Law of Limitation Act does not apply to banker's debt. The period of three years will be calculated from the date of demand for payment made but not from the date of deposit. Otherwise, the customers can not keep money with the bank for more than three years. Thus, once again the banker is a privileged debtor even in this case also.

(f) Right to combine accounts

The banker has the privilege to combine the accounts of his customers when a customer maintains more than one account in his name and in the same capacity.

It was decided in the case of Garnett Vs Mckervan that banker can combine the accounts of a customer even without prior permission. However, a prudent banker combines the accounts of his customer with prior notice.

In the case of Greenhalgh Vs Union Bank of Manchester it was established that a banker can combine the accounts of a customer only after obtaining their consent to avoid future complications.

(g) No Right to close the Account

An ordinary debtor can close the account of his creditor at any time. But, a banker can not close the account of his creditor at any time without his consent.

Thus, the debtor-creditor relationship holds good in the case of deposit account. But, in the case of loan, cash credit and over-draft, the banker becomes a creditor and the customer assumes the role of a debtor. In this case also, the banker is a privileged person because he is a secured creditor. The Law of Limitation applies to loan accounts unless they are renewed. Moreover, customers are insisted to submit security in case of loan accounts.

13.A.4 SUMMARY

The general relationship between banker and customer is that of a creditor and debtor. When money is deposited it amounts to lending by customer and the banker has a statutory obligation to repay as and when it is demanded by the customer. The banker can act as a bailee, trustee, executor, administrator, agent etc., depending the circumstances of situations. However, the most accepted

relationship between the banker and the customer is that of debtor and creditor but nothing else.

13A.5 SELF – ASSESSMENT QUESTIONS

Bailment

Bailor and Bailee

Banker as trustee

Banker as a Creditor

Banker as Executor

13A.6 ESSAY QUESTIONS

1) How can you say that a banker – customer relationship is similar to that of debtor – creditor relationship? Are there any exceptions.

2) What is the general relationship between a banker and his customer.

3) Discuss the general relationship between banker and customer. Illustrate your answer with reference to current a/c, loan a/c, fixed deposit a/c.

4) Explain in detail the statement. "Banker is a Privileged Debtor".

13A.7 SUGGESTED READINGS

* Theory and Practice of Banking : Reddy & Appannaiah
* Practice and Law of Banking : H.R. Suneja
* Banking and Financial Systems : Mithani & Gordon.

Dr. D. N. M. RAJU

Lesson - 14

RELATIONSHIP BETWEEN BANKER AND CUSTOMER–II SPECIAL RELATIONSHIP

14.0 OBJECTIVES

By the time you complete this chapter, you should be able to understand.

* obligation of banker to honour cheques.
* consequences of wrongful dishonour of cheques.
* banker's lien
* secrecy of customer's accounts
* right of combing accounts
* law of limitation
* right of set – off
* right of appropriation

Structure:

14.1 Introduction
14.2 Statutory obligation to honour cheques
14.3 Consequences of wrongful dishonour of cheques
14.4 Obligation to maintain secrecy of accounts
14.5 Consequences of wrongful dishonour of cheques.
14.6 Rights of a Banker
14.6.1 Right of Lien
14.6.2 Right to set – off
14.6.3 Right of appropriation
14.6.4 Right to close customer account
14.6.5 Right to cheque incidental changes.
14.7 Summary
14.8 Self Assessment Questions
14.9 Essay Questions
14.10 References

14.1 INTRODUCTION

The relationship between banker and customer arises out of the contractual relations between them. The primary relationship between a banker and his customer is that of a debtor and

a creditor. This relationship depends on the respective state of account between them. There are certain special features of the relation between a banker and a customer which have an important affect on the regular banking business. The special relationship between banker and customer are the obligations and rights.

The obligations or duties of the banker are the rights of the customer and the rights of the banker are the duties of the customer. Hence, it is apt to study the special relationship between the banker and the customer under two heads ie., obligations of the banker and the rights of the customer.

(I) Obligations of a Banker

The following are the obligations of a banker.

(A) 14.2 STATUTORY OBLIGATION TO HONOUR CHEQUES

The banker opens an account of the customer as per the rules of the bank. When a banker opens an account in the name of the customer, it become opens an account in the name of the customer, it becomes obligatory on the part of the banker to honour the cheques issued by the customers as long as he has sufficient funds in his account. However, the cheques drawn must be presented in a reasonable time and during he working hours.

The Negotiable Instruments Act, 1884 imposed a duty to honour the cheques by the banker. The obligation to honour the cheques is laid down 4/ S 31 of the Negotiable Instruments Act. According to this section, "the drawee of a cheque, having sufficient funds of the drawer in his hands, property applicable to the payment of such cheque, must pay the cheque when duly required so to do, and in default of such payment must compensate the drawer for any loss or damage caused by such default."

So, a banker has to honour the cheques of his customer under ht following conditions:

(a) When he has sufficient funds of his customer.

(b) When the funds are properly applicable for the cheque drawn.

(c) When the banker has required duty to pay.

(d) When the cheque is presented with in a reasonable time.

(e) When there is no Garnishee order against the customer's account.

This obligation of honouring cheques of the customer holds good even in case of over–draft cheques also.

In the case of Cunning Vs Shand, it is decided that "the banker's duty to pay customer's cheque would be extended even to over draft arrangements supported by valid consideration."

Further, in the case of Indian Overseas Bank, Madras Vs Naran Prasad Govindlal Patel, it is decided the over – draft arrangement between the bank and the customer can not be terminated without giving prior notice, even though it is a temporary one.

14.3 CONSEQUENCES OF WRONGFUL DISHONOUR OF CHEQUES

If the banker dishonours a cheque on reasonable grounds as mentioned above, the banker is justified in his duty. However, if he dishonours a cheque by mistake, it amounts to a wrongful dishonour. Even if a banker dishonours a cheque by over – sight, it amounts to negligence. To err is human. So, a banker may dishonour a cheque which is good for payment inspite of all the care taken by him. When a banker does so, he brings injury to the credit of the customer. In case of traders, the injury to their credit is more. So, he is liable to pay compensation to the customer for the loss or damage suffered by him. The damages are of two types ie. special damages and nominal damages. Special damages are paid to the traders and nominal damages to the non-traders. However, in some cases special damages may be paid to non-traders and nominal damages to the traders depending on certain circumstances.

In the case of New Central Hall Vs United Commercial Bank Ltd, it was divided that a trader could get special damages as the dishonour of the cheque would affect his goodwill and a non-trader could claim only nominal damages.

In the case of Gibbans Vs West Minister Bank, it was decided that Mr. Gibban a non-trader could get only nominal damages.

In the case of Sterling Vs Barclay's Bank, the court awarded only nominal damages though Mrs. Sterling was a trader.

In the case of Canara Bank Vs I.V. Rajagopal, the court awarded special damages even though Mr. I.V. Rajagopal was only a non-trader.

Another important point to be noted in respect of assessing damages is the lesser the amount of the cheque dishonoured, the more is the damages paid. It is because the courts give due weight to factors like the financial position, business reputation and the usage of trade.

In the case of Davidson Vs Barclays Bank, the banker dishonoured a cheque for a small amount of £ 2.15 sh by mistake. He was awarded special damages of £ 250 by court.

From above, it is clear that the damages will be assessed taking into consideration the loss to one's credit, goodwill or reputation irrespective of the fact whether he is a trader or non-trader.

14.4 OBLIGATION TO MAINTAIN SECRECY OF ACCOUNTS

One of the important obligations of a banker is not to disclose the state of customer's account. It is because such disclosure may adversely affect the customer's credit, goodwill and business. So, a banker is under obligation not to disclose any information about his customer's account either deliberately or intentionally.

In the case of Tournier Vs National Provincial Bank, it was held that the banker must not discuss the state of customer's account except under reasonable occasions.

If the banker fails in his duty, he is liable for damages.

This obligation continues even inrespect of closed accounts. However the obligation of a banker to maintain secrecy is not absolute. In the following circumstances, the banker may disclose the state of customer's account.

(a) Where it is a legal necessity.

(b) Where it is permitted under banking laws.

(c) Where it is to safe-guard public interest.

(d) Where it is to protect his own interests.

(e) Where it is a common courtesy (ie., exchange of information among banks).

(f) Where it is with the consent of the customer.

14.5 CONSEQUENCES OF WRONGFUL DISCLOSURES OF CHEQUES

The banker should not disclose the state of customer's accent except on reasonable occasions. If the banker is negligent in maintaining secrecy, he is liable pay damages. The following are the consequences of wrongful disclosures.

(1) Liability to third parties

The banker is liable to pay damages if the customers incur loss due to untrue information supplied by the banker.

(2) Liability to customer

The banker is liable to pay damages to the customer, if the customer suffers any material loss due to wrongful disclosure or expression of infavourable opinion about him.

14.6 RIGHTS OF THE BANKER

The following are the legal thoughts of a banker against his customer.

(a) Right of Lien

(b) Right to Set – off

(c) Right of Appropriation

(d) Right to charge incidental changes, interest etc.

(e) Right to close the account of the customer.

14.6.1 Right of Lien

Lien is the right of a person to retain the property of another until the debt is due. In other

words, it is the right of the creditor to retain the goods and securities in his possession belonging to the debtor until his debt is repaid. It is different from pledge, mortagage, hypothecation etc.

Kinds of Lien: Lien is of two types – Particular lien and general lien.

A particular lien is the right to retain the goods inrespect of a particular debt only. In other words, a particular lien applies to one or certain transactions only. It can be excessied by a person who has spent his time, labour and money on the goods or property retained. For example, a watch maker has a lien over the watch till the repair charges are paid.

A general lien is a right to retain goods not only inrespect of a particular debt but also in respect of the general balance due to him. It extends to all transactions. It is more extensive than particular lien.

According to section 171 of the Indian Contract Act, this right of general lien is available to bankers, factors, a Horneys of High Court, policy brokers unless and until there is no agreement to the contrary.

Banker's Lien

A Banker's Lien is always a general lien. His general lien confers on him the right to retain the securities in respect of the general balance due from the customer.

It was held in the case of Brando Vs Barnett that the bankers have a general lien on all securities deposited with them as bankers unless there is an implied contract which is inconsistent with lien.

According to Chorley, "banker lien is exceptional and carries with it the valuable right of sale and recomponent".

When a banker can Exercise lien

(i) The property must come into his possession as a banker.

(ii) The property is not entrusted to him for a special purpose.

(iii) The property must come into his hands law fully.

(iv) There is no agreement contrary to lien.

When a banker can not Exercise lien

The banker has no right of lien on the following properties of the customer:

(I) Safe custody deposits

The banks generally receive valuables like Jwellery and documents for safe custody. The banker do not receive them in the regular banking business. He receives them as bailee. Therefore, they are

not subject to lien as they are left with him for a specific purpose.

(II) Bill of Exchange

He can not exercise lien on bill of exchange.

For Example: A drew a bill on B for the amount due. B drew a bill on 'C' for the amount due in turn. B gave the bill drawn on 'C' to the bank for collection. B instructed the banker to use the proceeds collected to meet the bill accepted by him.

In this case, the proceeds held are not subject to banker's lien as they are entrusted for a special purpose.

(III) Money deposited for a special purpose

When money is deposited with banker for the purpose of purchasing securities and the banker has express or implied notice of such deposit, the deposited money can not be subjected to banker's right of general lien.

(IV) Documents or valuables left inadvertently

He can not exercise right of lien on documents or valuables left with him in advertently. Similarly, he can not exercise right of lien on properties which are obtained not as security for a loan to be granted.

(V) Amount not due

He can exercise his right of lien only when the debt becomes due.

(VI) Trust Accounts

When a customer operates a trust account with the knowledge of the banker, then the banker can not exercise his right of lien on trust accounts if the customer owes to bank on other accounts.

(VIII) Law of Limitation

Banker's lien is not affected by the Limitation Act as it bars the remedy but not the debts.

Differences between Particular and General Lien

Particular Lien	General Lien
Creditor can retain property of the debtor for non-payment of a particular debt only.	Creditor can retain any property for any amount due.
It is exercised by any person who has spent time, money etc on goods and securities retained.	It is enjoyed by few persons like bankers, factors etc,
It is not advantageous to the creditor.	It is more advantageous to the creditor.

14.6.2 Right of Set-Off (combining accounts)

Right of set-off is the right of combining the accounts between a debtor and a creditor with a view to determine the net balance payable to one or the other. In other words, it is a right of combining accounts. In order to exercise this right, the debt must be a sum certain, due by, and to the same parties an dint he same right. There are two different views on the banker's right to combine accounts.

In older days, the banker was allowed to combine the accounts kept by the same customer, if there is no written or oral agreement between them to the contrary. This opinion was observed in the case of Garnett Vs Mc Kervan. In this case Garnett has an over draft balance at one branch of a bank. He stopped his business after some years. He did not pay the over draft amount. He opened a new account with another branch of the same bank. The credit balance in the new account is more than the former over draft balance. The Bank combined the accounts. The Bank dishonoured the cheques of his customer drawn against second due to lack of sufficient funds.

It was decided by court that the banker can combine, the accounts as there was no agreement between them to maintain the account separately. It was decided that the banker need not even give a prior notice to combine accounts. However, giving a prior notice is proper. Thus, a banker can combine two accounts even at two different branches. This called 'Right of set-off'.

But, in the case of Greenhalgh V Union Bank of Manchester, it was held that the banker can not combine two or more accounts when he has agreed to open separately. If the banker wants to combine accounts he has to take the consent of his customer before. He must take atleast the precaution of sending notice. Otherwise, he becomes responsible for dishonouring of cheques drawn on the credit balances.

The banker can exercise his Right of Set-Off under the following conditions

1. There should not be any agreement between them to the contrary.
2. He must have given his notice of intention to combine.
3. The capacity of the customer must be the same in all accounts.
4. This right can not be exercised inrespect of future debts.
5. The amount due must be certain.
6. It is optional to the banker. Customer can not compel.
7. The banker can combine accounts even when there is a Garnishee order.

14.6.3 Right of Appropriation (Clayton's case)

When a customer owes several debts to a banker and makes payment which is not sufficient to clear all the debts, then the problem of appropriation will arise. The rule of appropriation is laid down in Clayton's case in England. In India, the rule of appropriation of payments is laid down in the Indian Contract Act. In this connection, it is important to remember the observations made by the learned judge in the case of Croft Vs Lumley. According to him, "There is an established maxim of law

that, when money is paid, it is to be applied according to the expressed will of the payer, not the receiver. If the party to whom the money is offered does not agree to apply it according to the expressed will of the party offering it, he must refuse it and stand on the rights which the law provides him".

The above rule can be explained clearly by the following illustration:

Date 2004	Particulars	Withdrawals Rs.	Deposits Rs.	Dr/Cr.	Balance Rs.
June 1	To balance	-	-	Dr	15000
6	By cash	-	10000	Dr	5000
8	To cheque	8000	-	Dr	13000
12	By chequr	-	9000	Dr	4000
14	To cheque	5000	-	Dr	9000

The banker has sanctioned an overdraft limit of Rs. 20000 in the joint names of Alpha and Beta. Their account appears as above in the ledger of the banker.

Alpha dies on 5th June 2004, and the accounts shows a debit balance of Rs. 15000 on this date. The banker requests for adjustment of the account on 14th June 2004. When the debit balance in the account stands at Rs. 9000. Now, the banker can claim this amount only from Beta and not from the estate of Alpha. This is because the debit of Rs. 15000 was cancelled by two credits ie., one on 6th July and the other on 12th June. This is what has been provided according to the rule in Clayton's case. This is not favourable to the banker. Therefore, the banker should stop operating the account as soon as the banker reserves the information of the death of one of his joint account holders. He should have opened a new account in the name of the surviving account holder immediately. If new account would have opened on the date of death of Alpha, Beta's account would have appeared as given below.

Date 2004	Particulars	Withdrawals Rs.	Deposits Rs.	Dr/Cr.	Balance Rs.
July 6	By cash	-	10,000	Cr	10,000
8	To cheque	8000	-	Dr	2,000
12	By cash	-	9000	Cr	11,000
14	To cheque	5000	-	Dr	6,000

In this case, though the net amount due is Rs. 9000 (ie., Rs. 15000-6000) as in the first case, but in such a case both Alpha and Beta estate are liable for this amount.

The Indian Contract Act laid down the following provisions inrespect of the appropriation of payments.

Appropriation by the Debtor (Sec 59)

When money is paid by the debtor to his creditor with a specific direction that the money so paid is to be applied to a particular debt, the creditor has to apply the money received to the debt as directed by the debtor. When the debtor has more than one debt and the creditor is not willing to

apply the money received on per direction of the debtor, then the creditor has to refuse to accept the money if he is not willing to appropriate as per the desire of the debtor.

The direction of the debtor for appropriation may be in the form of words spoken or by conduct. For example, if the debtor owes two debts one of Rs. 100 and other of Rs. 200 and pays Rs. 200, the creditor presumes that the intention of the debtor is to appropriate his payment to the second debt of Rs. 200 only.

Appropriation by the creditor (Sec 68)

When a debtor owes several debts and makes payment of amount to the creditor with out any direction to which the payment made is to be appropriated, then the creditor is at liberty to appropriated the amount so received as per his choice. The creditor may apply the amount to any lawful debt including a time - barred debts. If there are more than one time-barred debts, then the creditor may apply the repayments to the earliest as per the Limitation Act and sue in the court of law for the recovery of such debts or balance which are not time-barred. The creditor can exercise this right only when the debtor fails to exercise his right of appropriation. The creditor need not declare his intentions in any express form. Another important point is to be noted under this context is that when the creditor applies the payment received to one of the several debts outstanding according to his choice, and is not informed to the debtor, then the creditor afterwards can change it to another debt.

Where appropriation is not made by either debtor or creditor (Sec 61)

Where neither of the party makes any appropriation, The payment shall be applied to discharge the debts in order of time whether they are barred or not barred by the law in force. If the debts are of equal value, then the payment shall be applied to discharge the debts proportionately.

Payment of interest first

In case of a debt carrying interest, the creditor will apply the money received first towards the payment of interest and then the balance in payment of the principal amount if the debtor does not give direction to the creditor as to the appropriation of money paid.

14.6.4. Right to close the account of the customer:

Closing of account means putting an end to the relations between the banker and the customer. The customer may withdraw the balance in his account by drawing a cheque. However, the customer has to inform the banker of his intention to close the account. He is to return the unused cheques to the banker. Then the banker will settle the amount standing to his credit. Thus, if the customer wants to close the account he can do it without any complicated procedure.

According to Sheldon, “a banker cannot prevent a customer withdrawing his balance and closing his account”.

A customer may close the account with the banker for various reasons. They are:

(i) When the customer no longer needs a bank account.

(ii) When the customer suspects the solvency of the bank.

(iii) When the customer is not satisfied with the standard of services provided.

(iv) When the rate of interests and other terms followed by the bank are not competitive.

Closing of an account by the banker:

The banker can request the customer to close his account under the following circumstances:

(1) When the account becomes dormant.

(2) Frequent overdraft without arrangement.

(3) When post – dated cheques are issued frequently.

(4) When the customer countermands the cheques frequently.

(5) When the customer do not maintain minimum balance.

(6) When the customer is negligent in drawing cheques.

(7) When the customer commits breach of trust.

Under the above circumstances a banker can close the account of the customer after giving prior notice.

A banker can close the account of the customer without giving notice under the following circumstances

(i) On the death of the customer.

(ii) On the insanity of the customer.

(iii) On the insolvency of the customer.

(iv) On the notice of assignment transferring funds in the bank to another.

(v) On the issue of Garnishee order on banker attaching all funds of the customer.

14.6.5 Right to charge incidental changes, interest etc

The banker has the right to charge reasonable commission for the services rendered to customers. Banks cheque incidental charges on current accounts to meet incidental expenses on such accounts. The banker has also the right to charge interest on the loans and advances granted to the customers. The interest may be simple or compound depending on the terms of the contract.

14.7 SUMMARY

The banker has to honour the cheques of his customer as long as he has sufficient funds. The customer must present the cheques with in reasonable time and on working days and during the

working hours of the bank. The banker is justified in dishonouring post – dated cheques.

The banker is liable if the cheques are dishonoured by oversight, mistake or negligence. Under these circumstances he will not get protection.

Lien is the right to retain the property and securities of the debtor for the amount due. Lien is of two types. Particular lien and General lien. General lien is also called as Banker's lien.

The banker is under obligation not disclose the state of customers a/c under usual circumstances as it may lead to loss of goodwill or credit or reputation.

The banker has the right to charge compound interest on amount due to him from the customer.

14.8 SELF - ASSESSMENT QUESTIONS

(i) Obligation of banker to honour cheques

(ii) Banker's lien

(iii) Consequences of wrongful dishonour of cheques.

(iv) Secrecy of customer's account

(v) Right combine accounts

(vi) Right of set – off

(vii) Right of Appropriation

(viii) Commercial debt and banker's debt.

14.9 ESSAY QUESTIONS

1. What do you understand by banker's lien? When a banker can and can not exercise his right of lien?
2. When a banker can dishonour cheques? Explain the consequences of wrongful dishonour of cheques.
3. What is the duty of the banker in maintaining secrecy of customer account? State the circumstances when he is and when he is not justified?

14.10 REFERENCE BOOKS

1 Banking and Financial Systems : R.R. Paul & AVR Chary

2 Practice and Law of Banking : HR Suneja.

3 Indian Banking – Nature and Problems : Desai & Vasant

Dr. D. N. M. RAJU

Lesson - 15

ACCOUNTS OF CUSTOMERS

15.0 OBJECTIVES

After completing this lesson you should be able to understand:

* different types of account
* formalities to be complied with before the opening of an account.
* different deposit schemes introduced by the Government.
* different deposit schemes introduced by the banks
* concept of Dormant accounts.
* deposit Insurance and credit Guarantee Corporation of India.

Structure

15.1 Introduction
15.2 Deposit Accounts
15.3 Fixed Deposit Account
15.4 Savings Deposit
15.5 Insurance – Linked Savings Bank Deposit
15.6 Re- curring Deposit
15.7 Current or Demand Deposit Accounts
15.7.1 Characteristics of Current Account
15.7.2 Benefits to Current – Account Holders
15.8 Formalities required in opening Savings and Current Accounts.
15.9 Deposit schemes introduced by Government of India
15.10 Deposit schemes introduced by the Banks.
15.11 Dormant Accounts
15.12 Summary
15.13 Self – Assessment Questions
15.14 Essay Questions
15.15 References

15.1 INTRODUCTION

The main function of a banker is the accept deposits and lending loans. For this, the banker has to open accounts in the name of the customers. Whenever a banker opens an account of his

customer, it is necessary for the banker to know the customer's background, trade, business, profession and the type of account he is opening. The banker should take atmost care in opening accounts of the customers as it may cause harm to the interests of the bank and also to a third party later in case of negligence. Therefore, it is essential to know the general principles relating to the process of opening of accounts by the banker.

15.2 DEPOSIT ACCOUNTS

Deposit accounts are one of the important sources of bank's funds. To attract customers, the banks after a variety of facilities to various types of deposit account holders. In the process, the banks also may resort to unhealthy practices to woo the customers. To check this, the Reserve Bank of India is given the power to fix interest rates on deposits. No commercial bank in India can pay more interest on deposits than what is fixed by the R.B.I. However, the R.B.I has made certain relaxations inrespect of a smaller banks in this respect to protect their survival. This facilitates the smaller banks to compete with the bigger banks in the country. But, the R.B.I. fixes the minimum and maximum rates of interest. So, no bank can offer more or lesser rates of interest on its deposit accounts than what is fixed by the R.B.I.

After the Financial Sector Reforms, the R.B.I is adopting the policy of deregulation of interest rates. The R.B.I has abolished the rule of minimum lending rate. It has given freedom to banks in lending rates. It has also given freedom to banks to fix interest rates on deposits. Thus, banks in India are free to fix there rates of interest.

15.3 FIXED DEPOSIT ACCOUNT

They are also called term deposits. These are made with the bank for a period specified in advance. The banks need not maintain any cash reserves out of these deposits as the period of repayment is specified in advance. So, the banks after higher rates of interest on such deposits. There deposits form more than half of the total deposits of a bank.

Opening of fixed deposit account

The depositor has to fill in the application form. Depositor has to mention the amount of deposit, period of deposit, etc. He has to maintain whether the deposit receipt is to issued in single name or in joint name etc. In case of joint names, he has to maintain whether the payment is to be made jointly or payable to either or survival on maturity. The banker has to take the specimen signatures of the depositors. Accordingly, the banker issues a fixed deposit receipt containing the name to whom the payment will be made, the rate of interest and the due date of payment.

Payment of interest

Generally interest is paid on maturity of deposit. However, the banks pay interest monthly, Quarterly, half – yearly or yearly as per the option of the deposit – holder. The interest may be credited to the savings account or current account if the depositor so desires. The banks hav e introduced new plans of re-investment where the customer gets the benefit of compound interest.

Interest on order-due accounts

Generally, the banker pays no interest on deposits matured until and unless they are renewed. However, the banks have discretion to pay interest for over - due period provided the deposit is renewed from the date of its maturity and the rate of interest allowed does not exceed the rate of interest applicable to the period for which deposit has been renewed.

Advance against fixed deposits

Banks can grant advances upto 75% of the deposits against fixed deposit receipts. The rate of interest of such loan is generally 2% more than the rate of interest payable.

The banks have been formulating fixed deposit schemes suitable for senior citizens. They pay higher rates of interest as compared to normal deposit rates.

The deposit has to surrender the deposit receipt to the bank. The bank note down lien on the deposit receipt. It is returned to the borrower on repayment of the loan. The bank will note the fact of lifting lien on such fixed deposit receipt.

Surrender before maturity

The banker do not accept surrender of fixed deposit receipt before its maturity. However, if a revert is made by the customer, the banker accepts and makes payment even before maturity date. To discourage such practice, the banks pay 1 % less interest than what is applicable on normal deposits.

For example: The normal rate of interest is 5% on deposits over and above 45 days and 4.5% on deposit ranging between 30 to 45 days.

If the deposit is made for 46 days. The interest rate applicable is 5%. But withdraws after 44 days. He will be paid only 3.5% interest though for 44 days the normal rate applicable is 4.5%.

Deposit receipt is not Negotiable Instrument

It is not a negotiable instrument. It can not be transferred like cheque, draft etc. It can be assigned. The assignor should handover the deposit receipt to the assignee duly discharged. In such cases, the assignor gives up all claims on such deposits. But, the title of the assignee cannot be better than the assignor.

Deposit in Joint Names

A fixed deposit may be opened in joint names. In such a case, the difficulty is whether the payment is to be to any one of them or not. In the absence of any agreement, the payment should be made to all joint depositors or surviving depositors, including legal heirs of the deceased. In case of account operated by either or survivor, the amount may be paid to any one of the joint account holders. According to English Law payment may be made to any one of the joint depositors. But the Indian Law is not clear.

Cheques against fixed deposits

The customer is not entitled to draw cheques on fixed deposit account either before or after maturity of the deposit. On maturity it is paid either in cash is credited to customer's savings account or current account.

Exemption from Stamp Duty

It is exempt from stamp duty provided that the depositor and the payee are one and the same.

Loss of fixed deposit receipt

If the fixed deposit receipt is lost a duplicate receipt can be obtained by executing an Indemnity Bond. The banker should make a note of the fact on the fixed deposit ledger for his future guidance.

Change of names

At the request of the customer, the banker make additions or deletions on the fixed deposit receipts. The banker should be careful and act only as per the directions of the customer.

For example: In case a receipt is issued in the name of a unmarried lady and if she wants to change her name after her marriage the banker should obligue as it is a genuine case.

In case of request to add any name by the customer, the banker will have no objection as he has obtained the mandate from the customer.

In case the fixed deposit receipt is held by more than one person then the banker should get the request from all the concerned depositors to make any additions.

In case of death of depositor, the amount will be held jointly in the names of all legal heirs.

Donatio Morits causa

A fixed deposit receipt can be given as donation. The donee can claim the amount. So, a fixed deposit receipt may be the subject of a donatio morits causa.

The above observation is made in the case of Duffin Vs Duffin.

Fixed Deposit Receipt and Law of Limitation

The law of limitation not applicable to fixed deposit as long as interest is paid or deposit is renewed. If the deposit is not renewed, the period of limitation starts from the due date of the deposit.

Is fixed deposit holder a customer?

There is a difference of opinion inrespect of a deposit holder whether he is a customer or not. Generally, he is a customer as he has some sort of an account with a banker. However, he can not be

treated on par with a regular customer of a savings deposit or current deposit as there is no frequency in the number of transactions.

15.4 SAVINGS DEPOSIT

These deposits are mostly of small amounts. The main object of this account is to promote the habit of savings. There are restrictions on the number of withdrawals in a month. Interest is allowed on monthly balances. The cheque facility is also available in case the depositor maintains a minimum balance.

This account can be opened with a minimum of Rs. 500. Some banks of India Personal Banking Branches and the New Private Sector Banks keep the minimum as Rs. 2000 to Rs 5000. All most all Public Sector Banks keep Rs. 500 without cheque facility and Rs. 1000 with cheque facility. If the fixed minimum balance is not maintained, incidental charges will be levied. Instant credit facility is available to customers to a limited extent for their outstation cheques provided that such cheques are not related to trading business. It is a privilege given to non- traders.

The depositor is supplied with a pass book. Withdraws are not allowed if the pass - book is not presented along with the withdrawal slip. Saving bank holders can withdraw money by means of cheques, debit- cards ATM cards, in addition to the other facilities is like e – banking, tele – banking etc. nomination facility is also available in savings Bank Accounts.

15.5 INSURANCE – LINKED SAVINGS BANK DEPOSIT

In the present days, some banks are offering the additional benefit of life insurance coverage besides the usual benefits of savings deposit account. The insurance coverage is a free service. The depositor has to maintain a minimum balance of Rs. 500 in case of branches in rural areas and Rs. 1000 in case of urban areas. In case of death of the account holder, the legal heirs are entitled to the benefit of insurance to the extent of double the average balance in the account if the account – holder is between 18 to 40 years of age. The maximum benefits is limited to Rs. 10000. In case of account holders in between 41 to 49 years of age the benefit is limited Rs. 5000. Later, this benefit of insurance average on deceased accounts ceases. It is a boon to the persons who die prematurely.

15.6 RECURRING DEPOSIT

It is another type of savings deposits. A fixed amount is deposited regularly every month till the agreed period. After the agreed period the depositor gets a sizeable amount. It is helpful to meet the contingent expenses of the depositors. This scheme works on the maxim, “little drops of water makes a big ocean. It is almost equal to fixed deposits. If the depositor wants to transfer his account from one branch to another, he can do so without any changes. It is also called Cumulative Deposit Accounts.

15.7 CURRENT OR DEMAND DEPOSIT ACCOUNTS

In the case of current or Demand Deposit Accounts, the banker has an obligation to honour the cheques drawn by his customer as long as the account shows a positive balance. The current account can not become time – barred as it is a running account.

15.7.1 Characteristics of current Account

1. The main object is to safe – guard the customers like big businessmen, joint stock companies, public authorities etc from the risk of handling large cash balances.

2. The cost of providing facilities to current accounts is negligible to the banks as they undertake to collect cheques, drafts and make payments for any number of times in a day. Generally, no interest is paid on these accounts by banks and on the other hand the banks charge some incidental charges on such accounts.

15.7.2 Benefits to Current – Account Holders

(a) The banks collect third party cheques for their current account holders.

(b) The banks provide over draft facility to such account holders.

(c) Banks grant loans and advances through current accounts. Generally, loans are credited to the current accounts and cash is not paid across the counter.

15.8 FORMALITIES REQUIRED FOR OPENING SAVINGS AND CURRENT ACCOUNTS

(i) The person opening a current or savings account must make an application in prescribed form. In the application he has to mention clearly his name, address, occupation etc., as required by the bank.

(ii) He has to submit two photographs. One is to be pasted on the application form and the other on the specimen signature sheet.

(iii) He has to give two references. The banker may make an enquiry from the references given regarding the character, honesty, integrity etc of the applicant. The introduction of the applicant must be made by the existing customer of the bank. He has to sign on the application. The person so signing must give his account number and his address.

(iv) He has to submit his specimen signatures on the cards as required by the banker.

(v) If he wants to operate his account by any other person on his behalf, the bank will take the man date in writing to that effect. The banker obtains the specimen signatures of the agent who is to act on behalf the customer.

(vi) After the completion of the above formalities, the banker opens an account in the name of the applicant. The applicant has to deposit the minimum amount required to open an account by the bank. The minimum amount varies from bank to bank. The minimum amount varies from Rs. 500 to Rs. 5000.

15.9 DEPOSIT SCHEMES INTRODUCED BY GOVERNMENT OF INDIA

National Housing Bank Scheme, 1991

It is formulated by the National Housing Bank. It is owned by the Reserve Bank of India. The

main object of this scheme is to channelise black money for social objectives. An account can be opened with an count of Rs. 10,000. Further deposits can be in multiples of Rs. 1000. The advantage of the scheme is that the depositor need not disclose the source of deposit under any circumstances. No interest is paid on these deposits. He can get direct tax exemptions on this deposit. 60% of the total amount deposited can be withdrawn immediately and the balance of 40% will be used for financing low cost housing for poor.

New Deposit Scheme for NRI, 1992

The Government of India introduced this scheme to mobilise deposits and attract foreign exchange on a non-repatriable basis. The transfer of foreign exchange from non-residents to this account is converted into rupees at the existing exchange rates. Deposits ranging from a period of 6 months to 3 years are accepted. The deposits are free from reserve requirements. The banks are free to determine the deposit and lending rates under this scheme.

Insurance of Bank Deposits

The idea of insuring bank deposits was introduced to promote public confidence in the banking system. In 1930, the Rural Banking Enquiry Committee considered the scheme of Insurance of Bank Deposits. In 1953 the Shroff Committee submitted a draft scheme for setting up of Deposit Insurance Corporation till 1960, no steps were taken in this regard. In 1960, the Palai Central Bank Limited and the Lakshmi Bank Limited failed. This made the Government of India and the Reserve Bank of India to realise the importance of setting up a Deposit Insurance Corporation. The Act was passed in1960 and the Deposit Insurance Corporation was established with effect from 1st January, 1962. It is now known as Deposit an Credit Guarantee Corporation of India. The corporation operates both the deposit insurance and credit guarantee schemes.

15.10 DEPOSIT SCHEMES INTRODUCED BY THE BANKS

In addition to the above schemes, many banks have introduced several innovative schemes to attract deposits from the public. Some of these deposit schemes are mentioned below.

(i) Multi Deposit Scheme

In general, if the depositor wants to withdraw money from his fixed deposit he has to break the deposit. He can avail a loan or an overdraft on his deposit. In such cases, he has to pay higher interest on the loan or overdraft borrowed than what is paid to him on his deposit.

But, in case of multi deposit scheme the deposit is free to use his money deposited without losing interest or paying additional interest. In this scheme the depositor has to deposit a minimum of Rs. 1000. The deposit may be in the multiplies of Rs. 1000 or any other amount as the case may be. In such a case he can use the money in multiples of Rs. 1000 whenever he wants. The balance of the deposit amount is subject an attractive rate for the remaining period. The depositor can withdraw by cheques and bank cards also.

The multiple deposit scheme is introduced for the first time in India by the City Bank.

(ii) Time – wise Savings Schemes

The depositor saves time in this type of scheme than money. He features of the scheme are:

(a) He has to open the deposit account with a minimum of Rs. 10,000.
(b) His account is credited with interest regularly at the agreed rates applicable to savings all.
(c) He is sent a statement of account quarterly free of cost.
(d) In case of his absence, his agents also can operate his accounts.
(e) He has access to any branch of the bank in addition to the branch where he has the account.
(f) On his instructions, the banker pays the routine bills.

This scheme is first introduced in India by ANZ Grindlays Bank.

(iii) Smart Money Scheme

In this scheme the depositor can withdraw 75% of the deposit by issuing a cheque. He gets the rate applicable to fixed deposits on the remaining balance.

This scheme is first introduced in India by the Hong Kong Bank.

(iv) ATM Scheme

In this scheme, the depositor can withdraw, deposit and check the balance. He can transfer money and order for cheque book whenever he wants.

This scheme is introduce in India by the City Bank and Hong Kong Banks.

(v) Automatic Extension Deposit Scheme:

In this scheme, the depositor makes lumpsum payment and the deposit can be renewed for any term after the expiry of the specified period.

15.11 DORMANT ACCOUNTS

It is also called inactive account. If the customer does not make any transactions for a long period, the account becomes a dormant account. Every bank has its only policy in this respect. The banker makes an effort to contact the customer by using the available means of communication. If he fails in his attempts the account is called dormant account.

The following are some of the reasons for an account to become inactive or dormant. They are:

(1) The depositor might have moved from one place to another without informing his banker.
(2) He must have mis-placed his pass-book and forgotten the existence of an account with a particular bank.
(3) The depositor might have died without the knowledge of the banker and soon.

The banker may remove the dormant accounts from the active ledgers and maintain a dormant ledger for better and effective control. The dormant accounts are exposed to lot of risks by the employees of the banks as there will not be any checks by the customers. To prevent frauds inrespect of Dormant Accounts, they can be transferred to one ledger. In other words, the balances in dormant accounts are transferred from active ledgers to dormant ledgers to have better and effective control. If the balance amount is large in dormant account, care must be taken to ensure that no fraud takes place. If the balance is minimum, it is not a matter of concern to the banker.

15.12 SUMMARY

Generally, deposits form major source of funds to the bank. The accounts are classified into fixed, savings, current and recurring deposit accounts. Fixed deposit accounts carries higher rate of interest. Savings deposit interest is less. Current account carries no interest. Fixed deposit is suitable to the persons who does not require money for the present consumption. Restriction are placed inrespect of withdrawals of savings account. They are suitable to employees. Current account is suitable to traders, businessmen etc. Inrespect of recurring deposit fixed amount is deposited monthly for a certain period. In case of bank failures, deposit upto Rs. 1,00,000 is covered under the Deposit Insurance and credit Guarantee Corporation of India. The account becomes inactive if it is not operated for a long period. In such cases, the balances in dormant account is removed from active ledger and is transferred to dormant ledger to prevent fraud from cheats.

15.13 SELF – ASSESSMENT QUESTIONS

Fixed deposit account
Savings bank account
Current account
Re-curring deposit account
Dormant account
Deposit Insurance and Credit Guarantee Corporation of India.

15.14 ESSAY QUESTIONS

1. What are the different types of account that can be opened in a bank?
2. State the significance of Fixed Deposit Receipt?
3. Explain the various deposit schemes introduced by the Government.
4. Explain the different deposit schemes introduced by the banks.

15.15 REFERENCES

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Dr. D. N. M. RAJU

Lesson - 16

NEGOTIABLE INSTRUMENTS ACT

16.0 OBJECTIVES

After completion of this lesson you should be able to understand.
* meaning and definition of negotiable instruments.
* characteristics of Negotiable Instruments such as bills of exchange, promissory notes and cheques.
* holder in due course.
* types of crossing of cheques.
* types of endorsements
* material alteration

Structure

16.1 Introduction
16.2 Meaning and Definition of Negotiable Instruments
16.3 Characterstics of Negotiable Instruments
16.3.1 Legal presumptions of Negotiable Instrument
16.4 Promissory Note – its characterstics.
16.5 Bills of Exchange – its characterstics
16.5.1 Differences between B/E and Promissory Note.
16.6 Types of Bills
16.7 Cheques
16.8 Differences between B/E and a Cheque
16.9 MICR cheques
16.9.1 Draft
16.10 Holder and Holder in due course
16.10.1 Privileges of Holder in due course
16.10.2 Differences between Holder and Holder in due course
16.11 Crossing of cheques
16.12 Endorsement and its Types
16.13 Material Alteration
16.14 Summary
16.15 Self – Assessment Questions
16.16 Essay Questions
16.17 References

16.1 INTRODUCTION

The law relating to Negotiable Instruments is contained in the Negotiable Instruments Act, 1881. The Act extends to the whole of India except to the state of Jammu and Kashmir, but nothing here in contained effects the provisions of section 31 of the Reserve Bank of India Act, 1934 and the local usages relating to Hundis. The court can apply rules relating to the negotiable instruments wherever there is no customary rule on a certain point.

The Act came into effect from 1st March, 1882. The Act is amended in 1988. The Amended Act came into force on 30th December, 1988.

16.2 MEANING AND DEFINITION

Negotiable instrument means a 'written document'. It creates a right in favour of some person. It is freely transferable.

According to section 13 of the Negotiable Instruments Act, a negotiable instrument means, "a promissory note, bill of exchange or cheque, payable to order or bearer either with or without the words order or barer.

The act recognises mainly a promissory note, a bill of exchange and a cheque as negotiable instruments. This does not mean that the Act includes other instruments like Dividend warrants, Post trust debentures, Railway receipts as negotiable instruments as they satisfy the characterstics of negotiability. However, money orders, and postal orders, deposit receipts, share certificates, bill of lading, dock warrants etc are not negotiable instruments.

16.3 CHARACTERSTICS OF NEGOTIABLE INSTRUMENTS

(i) Negotiability

The Ownership in a negotiable instruments can be transferred without any formality. The transferor confers not only the right to possession but also the right to ownership by the transferee. In case of bearer instrument the property can be transferred by more delivery and in case of order instrument, the property can be transferred by endorsement and delivery.

(ii) Title

The bonafide transference is not affected by the defect in the title of the transferor or any party. The maxim "Nemo dat quod non habet" does not hold good inrespect of Negotiable Instruments.

(iii) Recovery

The holder in due course is entitled to sue on the instrument in his own name. He need not give notice to any person liable for payment on the instrument.

(iv) Transfer

It can be transferred any number of times before its maturity.

(v) Presumptions

It is always subject to certain assumptions. They are applicable unless otherwise proved.

(vi) Contract

It contains either an order or a promise to pay a certain amount. In other words, it possesses the characterstics of a valid contract.

16.3.1 Legal presumptions of Negotiable Instrument

The following legal presumptions are made under section 118 and 119 of the Act until the contrary is proved.

(1) It is assumed that every negotiable instrument is drawn, accepted, endorsed or transferred for consideration.

(2) That the date it bears is the date on which it was made.

(3) That it is accepted with in a reasonable time and before maturity.

(4) That every transaction is made before maturity.

(5) That the endorsements are regular.

(6) That the cost instrument is duly signed and stamped.

(7) That every holder of a negotiable instrument is a holder in due course until and unless it is received from the lawful owner by means of fraud.

All the above presumptions are rebutable by the aggrieved party by evidence. These presumptions are not valid if the instrument is obtained by fraud or unlawful consideration.

16.4 PROMISSORY NOTE

It is another important type of Negotiable Instrument. According to section 4 of the Act, a promissory note is, “an instrument in writing, containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, certain person, or to the bearer of the instrument.

Characteristics of a Promissory Note

(i) It is an instrument in writing.

(ii) It is an promise to pay.

(iii) It is an undertaking to pay unconditionally.

(iv) It is to be signed by the maker

(v) The maker must be certain

(vi) The payee must be certain

(vii) The promise is to pay money only

(viii) The amount to be paid must be certain.

16.5 BILLS OF EXCHANGE

According to section 5 of the Negotiable Instruments Act a bill of exchange, is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument.

Characteristics of a Bill of Exchange

(i) It must be in writing.

(ii) It must be signed by the drawer

(iii) The drawer, drawee and the payee must be certain

(iv) The sum payable must be certain.

(v) Should be stamped properly

(vi) It must be an order to pay money only.

(vii) The order must be un –conditional.

16.5.1 Difference between a Bill of Exchange and a Promissory Note

BILL OF EXCHANGE	PROMISSORY NOTE
1. No. of Parties: There are three parties viz, drawer, drawee and payee.	1. There are only two parties. viz maker and payee.
2. Promise and order: It contains an order to pay.	2.It is a promise to pay.
3.Acceptance: Drawee must accept.	3. It does not require any acceptance.
4. Liability: It is secondary and conditional.	4. It is primary and absolute.
5. Notice of Dishonour: It must be given to all the prior parties to the bill.	5. It is not required.
6. Protest: A foreign bill must be protested for dishonour if required by law.	6. It need not be protested for dishonour.
7. Payable to bearer: It can be made payable to bearer.	7. It can not be made payable to bearer.
8. Sets: It may be drawn in sets.	8. It can not be drawn in sets.
9. Drawer and Payee: Drawer and payee may be only one person.	9. It can not be because a maker can not make payment for himself.

16.6 TYPES OF BILLS

(a) Trade Bill

In the regular curse of course of business, the trade bills are drawn and negotiated and aid on maturity finally.

(b) Accommodation Bill

A bill may be drawn by traders to meet their mutual financial needs. Accommodation bill is drawn to meet the personal requirements of the parties to the bill. It is not a result of genuine trade transaction. There will be no debtor-creditor relationship between the parties to the bill.

Example: 'A' draws a bill an 'B' and 'B' accepts it. 'A' discounts the bill with his bankers and receives the proceeds on due date 'A' pays the amount of the bill and 'B' pays, the amount to the banker.

If 'B' also needs money then 'A' and 'B' may agree to share, the proceeds of the bill in some ratio at the time of drawing the bill. At the time of maturity 'A' and 'B' jointly pay the banker.

(c) Fictitious Bill

When the name of the drawer or payee or both are fictitious in a bill, it is called a fictitious bill. In such cases, the acceptor is liable to the holder in due course if he shows that the signature of the supposed drawer and that of the first endorser are in the same hand writing.

(d) Documentary Bill

When the documents to title to the goods like invoice, insurance policy etc are attached to a bill, it is called a documentary bill.

(e) Clean Bill

When no documents to title to goods are attached to a bill, the bill is called a clean bill.

(f) Escrow

When a negotiable instrument is delivered to person either conditionally or for safe custody, but not for the purpose of negotiation is called escrow.

(g) Inland bill

A bill which is drawn in India on a person residing in India is called an Inland bill. The bill may be payable either in India or outside India. If a bill is drawn in India on a person residing outside India, but payable in India is also called an Inland bill.

(h) Time bill

A bill payable after a fixed period is called a time bill.

(i) Demand bill

A bill payable on demand is called a demand bill.

16.7 CHEQUES

It is an important document in the commercial world. Originally it is spelt as check. The modern spelling of cheque is introduced by Gilbart for the first time. It's origin is not clear. According to Gilbart, it is derived from the French word Eschecs meaning 'chess'. Some are of the opinion that the origin of cheque can be traced to be notes issued by the Goldsmiths of London in the early periods. The modern cheque is the result of old trials. There is an interesting case where a cheque is written on the back side of a low in the earlier days. Thank God, it is never written on the face of a man.

Now, all commercial banks issue their own standard printed forms of cheques. It is not a legal tender money but can be converted into one at any time. They are drawn against the funds in the hands of the banker. They act as currency notes in these modern days. The cheque currency is very popular in all places of commercial importance. It is cheaper to print than a currency note. It can be crossed to ensure safety. A paid cheque acts as a voucher. Being a negotiable instrument it can be transferred any number of times before its due date. It is the safe method of money transaction. Even if a cheque is forged the paying banker is liable for the loss provided that the customer is not negligent.

Definition of a Cheque

According to section 6 of the Negotiable Instruments Act, it is a, "bill of exchange drawn on a specified banker and not expressed to the payable otherwise than on demand".

Essentials of a Cheque

(i) It is an instrument in writing.

(ii) It contains an un-conditional order.

(iii) It is drawn on a specified banker.

(iv) Payee must be certain.

(v) It is drawn for a certain sum of money.

(vi) It is payable on demand.

(vii) It is to be signed by the drawer.

16.8 DIFFERENCES BETWEEN A BILL OF EXCHANGE AND A CHEQUE

Bill of Exchange	Cheque
1.Drawer: It is drawn on any person including a banker.	1. It is drawn on a banker only.
2. Payment: It is payable on demand or on the expiry of the period.	2. It is payable only on demand.
3. Days of Grace: After certain period of time three days of grace are allowed on bills.	3. No days of grace are allowed.
4.Acceptance: It is to be accepted by the drawee.	4. It does not require any acceptance.
5. Payable on demand to bearer: It cannot be made payable to bearer on demand.	5. It is payable on demand to bearer.

6. **Notes of dishonour:** It is necessary.	6. It is not necessary.
7. **Stopping of payment:** After acceptance the payment cannot be counter manded or stopped.	7. The payment may be counter manded at anytime before payment.
8. **Crossing:** It can not be crossed.	8. Can be crossed either generally or specially.
9. **Stamp:** It must be stamped properly.	9. Does not require stamping.
10. **Statutory Protection:** No such protection is available to the acceptor.	10. Statutory protection is given in some cases.
11. **Noting and Protest:** It may be noted or protested for dishonour.	11. It is not required.

16.9 MICR CHEQUE

MICR means Magnetic Ink Character Recognition. Recently, the RBI has introduced this technology to speed up the processing of clearance of cheques. Cheques are processed by machines. Banks issue cheques in MICR format. They are made out of special quality paper. The instruments contain a code lime at the bottom where information printed in magnetic ink. The drawer should sign only above the code line. Nothing should be written on the code line.

16.9.1 Bank Draft

Bank drafts are bills drawn on demand or otherwise by one banker on another in favour of a third party or by one branch of a bank on another branch of the same bank. A demand draft is a bill of exchange drawn by a bank on another bank and is a negotiable instrument.

16.10 HOLDER

According to section 8 of the Negotiable Instruments Act, a holder means, any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto."

From the above definition, a holder will have the possession of the instrument and also the right to receive the money in his own name. He must hold the instrument under legal title.

This implies that more possessing of the instrument is not sufficient. For example: a binder of lost goods or a thief cannot be a holder. Similarly, an agent in possession of an instrument is also not a holder. But legal representatives of the deceased holder or official assignee are recognised as holders under law. It is the holder alone who can give a valid discharge for the instrument.

Holder in due-course

He is called a bonafide holder for value without notice in English law. He must acquire the negotiable instrument before maturity.

According to section 9 of the Act, "any person who for consideration became the possessor of a negotiable instrument, if payable to bearer; or the payee or endorsee thereof, if payable to order,

before the amount mentioned in it becomes payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title."

Thus, a holder in due course is one who:

(a) is in possession of the instrument in accordance with section 8 of the Negotiable Instruments Act.

(b) obtains possession of the instrument before maturity.

(c) obtains possession of the instrument for valuable consideration.

(d) is a holder, without having sufficient cause to behave that any defect existed in the title of the person from whom he received his title.

Thus, a holder of a Negotiable Instrument will not be a holder in due course if:

(a) he has obtained the instrument by gift or

(b) he has obtained the instrument for unlawful consideration or

(c) he has obtained the instrument after maturity or

(d) he has obtained the instrument by some illegal method or

(e) he has not obtained the instrument in good faith.

16.10.1 Privileges of a holder in due course

In the law of Negotiable Instruments he occupies an important position. He has a title free form all defects. He enjoys certain benefits or privileges which an ordinary holder can never possesses they are as follows:

(1) The instrument is free from all defects

It becomes a current coin once the instrument passes through the hands of the holder in due course. Any person who receives the instrument from the holder in due course can recover the amount from all parties prior to such holder.

(2) Liability of prior parties

All parties continue to remain liable to a holder in due course both jointly and severally until the instrument is duly satisfied. Where as only preceding party is liable to a succeeding party if the succeeding party is only a holder.

(3) Better title in case of inchoate instrument

A person who has signed the instrument and delivered a stamped but incomplete instrument cannot argue against a holder in due course that the instrument has not been completed as per the authority given to him.

(4) Privilege in case of Fictitious Bills

When a bill of exchange is drawn in a fictitious name and is made payable to the order of the drawer, the bill is said to be fictitious bill. Such a bill is not a good bill and cannot be enforced at law. But the acceptor of such a bill is liable to a holder in due course provided that the later can prove that the first endorsement and the signature of the supposed drawer are in the same hand-writing.

(5) Privilege when an instrument delivered conditionally

Where an instrument is delivered conditionally to a holder in due course, the other parties can not escape liability on the reason that the delivery was conditional.

(6) Estoppel against denying original validity of the instrument

The plee of original invalidity of the instrument cannot be put forth against the holder in due course by the drawer of a bill of exchange or cheque or by an acceptor of a bill for the honour of the drawer.

(7) Estoppel against denting capacity of payee to endorse

No maker of a note and no acceptor of a bill payable to order shall, in a suit there on by a holder in due course, be allowed to deny the capacity of the payee at the date of the note.

(8) Estoppel against denying signature or capacity of prior parties

An endorser of a bill by his endorsement guarantees that all the previous endorsements are genuine and the parties had the capacity to enter into valid contracts.

Therefore, he can not deny the capacity to contract of any prior party to the instrument subsequently.

(9) Every holder is a holder in due course

The law assumes that every holder is a holder in due course though the assumption is rebuttable.

16.10.2 Differences between 'holder' and 'holder' in due course

1. A holder can possess the instrument in his own name but the holder in due course acquires the possession for consideration.
2. Consideration is not necessary in case of holder. But it is essential in case of holder in due course.
3. A holder may get the instrument once it becomes payable. But the holder in due course must get the instrument before its maturity.
4. A holder can not get good title, if the title of the prior parties is defective. But it is not so in case of holder in due course.
5. Every holder in due course is a holder, but every holder need not be a holder in due course.

16.11 CROSSING

A cheque without crossing is called an open cheque. An open cheque or bearer cheque is exposed to many risks. Crossing is introduced to protect it from these risks. Crossing of cheques is started for the first time accidentally. It is Irwin who has sown the idea of clearing House. He is a bank employee. So, Irwin can be called as the Father of Crossing. In olden days, the bankers used to stamp their names on cheques while passing the cheques through clearing houses. This facilities the clerks of the clearing houses to make up their accounts. Moreover, stamping ensures safety to cheques. Otherwise, there is a danger of cheques being robbed by the employees of the banks while carrying them to clearing houses.

This created awareness among the public in general and the traders in particular. So, they started using the Words & Co whenever the name of the payee bank is not known to them. However, it is not recognised outside the clearance.

Crossing of cheques became a matter of legislation in the year 1856. In the earlier days there is a debate whether any erasing of crossing amounts to material alteration or not. This can be clearly seen from the following decisions.

In Simmons Vs Taylor, it is decided that crossing is not an integral part of the cheque and its erasing does not amount to material alteration or forgery.

In Bellamy Vs Morjori Banks, it is decided that crossing on the face of the cheque do not form part of the instrument and hence, it will not effect the business operation of the instrument in any way. This opinion is nullified by the Act of 1858. According to this Act, crossing is a material part of the instrument and any alteration in it amounts to forgery. It is this Act that has paved the way for the foundation of the law of special crossing. The Act of 1858 is Amended in the year 1876.

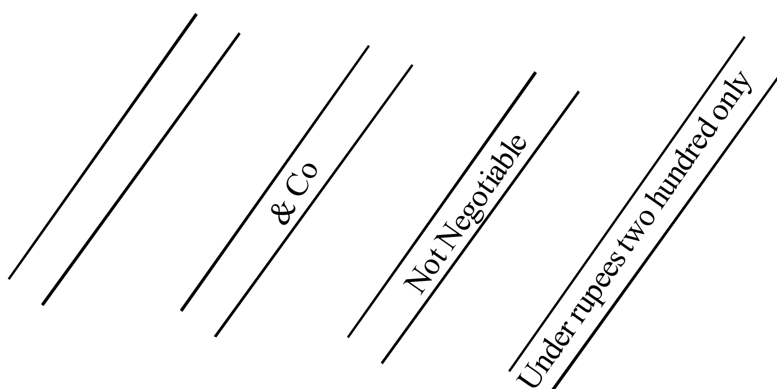
Kinds of Crossing

A cheque is said to be crossed generally when it bears two transverse parallel lines with or without any words are drawn on the left hand top corner of the cheque. The Negotiable Instruments Act provides two types of crossing. They are General Crossing and Special Crossing.

General Crossing

Where a cheque bears across its face two transverse parallel lines with or without any words, it is called General Crossing.

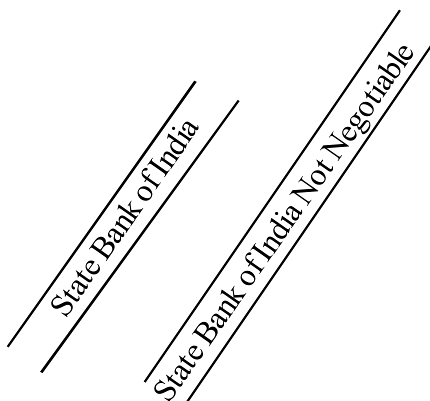
Words such as ‘and company’ or any other abbreviation may be written in between these two transverse parallel lines, either with or without words not negotiable. Absence of these words would not affect the validity of the crossing. In this case, the banker makes payment only to some other banker whose name is mentioned in the cheque.



The addition of the Words & Co does not have any legal effect in crossing. But the addition of the words ‘not negotiable’ has legal effect. These words, ofcourse do not take away the characteristics of negotiability but restricts it. It is because in this case the transferee will not get a better title than that of the transferor. If the title of the transferor is defective, the holder also gets only a defective title even if he happens to be a holder in due course.

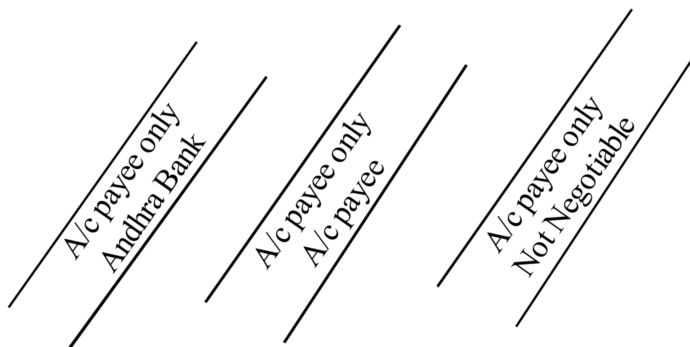
Special Crossing

Where a cheque bears across its face an addition of the name of a banker with or without the words ‘not negotiable’ it shall be deemed to be a special crossing. In this case, the banker on whom it is drawn will make payment to that banker in whose name it is crossed.



Restrictive crossing

In recent years, in addition to the above two methods, other methods of crossing of cheques with the words “account payee” or account payee only” has come into being. Such a crossing is called “restrictive crossing”. In such cases, the collecting banker will credit the proceeds of the cheque to the account of the person whose name is mentioned in the instrument. If the collecting banker credits the proceeds to some other account, he may be held liable for wrongful conversion of funds. The paying banker is not effected in any way. His duty is to see that the cheques are presented for payment by any bank in case of general crossing and by a particular bank in case of special crossing.

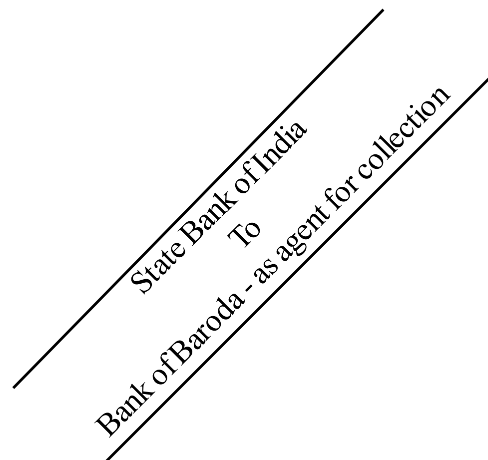


From above, it is clear that for crossing there must be two transverse parallel lines across the face of the cheque. Otherwise the cheque will not be treated as crossed.

Double crossing

When a cheque bears two separate special crossings, it is said to be crossed doubly. According to section 127 of the Act, "where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment there on.

Thus, a paying banker will pay a cheque doubly crossed only when the second banker is acting only as the agent of the first collecting banker.



In all other cases, the paying banker should refuse payment on a cheque bearing double crossing.

Obliterating a Crossing

Section 89 of the Act, gives protection to a collecting banker whose crossing is obliterated or erased by dishonest persons. The paying banker will be discharged from his liability in such cases if:

(a) Obliteration of crossing is not apparent at the time of its presentation for payment and

(b) The payment has been made in due course as required under the Act.

Opening of Crossing

It means cancellation of crossing on the cheque. It can be done only by the drawer. He has to put his signature and write 'pay cash' on the cheque after cancellation.

16.2 ENDORSEMENT

Endorsement of a negotiable instrument means writing a persons name on the back of instrument for the purpose of negotiation. The person who signs the instrument for the purpose of negotiation is called the 'endorser'. The person to whom the instrument is endorsed is called the 'endorsee'. The object of endorsement is negotiation or transfer of the instrument.

Definition of Endorsement

Sec 15 of Negotiable Instruments Act, 1881 explains endorsement as, "writing of a person's name by the maker or holder of a negotiable instrument, on the face or back of it, or on a slip of paper annexed to it, for the purpose of negotiation.

Essentials of valid Endorsement

(i) It must be on the face or back of the instrument.

(ii) It must be made in ink.

(iii) It must be made by the maker or holder.

(iv) It must be signed by the endorser.

(v) It must be completed by the delivery of the Instrument.

(vi) It must be for the entire bill.

Kinds of Endorsement

Endorsement may be of any of the following kinds:

(1) General or Blank

(2) Special or in full

(3) Partial

(4) Restrictive

(5) Conditional

   (a) Sans recourse

(b) Facultative

(c) Sans frais

(d) Liability dependent on a contingency.

1. Blank or General Endorsement

In this type, the maker signs on the back of the negotiable instrument his name only. He does not mention the name of the endorsee. Such an endorsement makes an order instrument payable to the bearer and the property in it can be transferred by mere delivery. There is no difference between a negotiable instrument endorsel in blank and one payable to the bearer.

Example

A bill is payable to the order of A. A signs on the back of the bill. This is an endorsement in blank by A. The bill becomes payable to bearer and is negotiable without any further endorsement.

2. Special or Full Endorsement

In this type, the name of the endorsee is stated. The person signing adds direction to pay the amount to or to the order of a specified person. It can easily be converted into special endorsement by any holder of a negotiable instrument.

Example Pay to A or order
Pay to order of A.

3. Partial endorsement

A Negotiable Instrument can not be endorsed for a part of its value. A partial endorsement is invalid. It is because, partial endorsement will cause inconvenience to prior parties. Law does not permit apportionment of personal contract. There is an exception to this rule. If an instrument is paid, the fact of such payment must be endorsed on the instrument. Then, the instrument may be negotiated for the balance.

Example

A is the holder of a bill for Rs. 600. He writes on it pay Rs. 200 to B. The endorsement is invalid.

A is the maker of a promissory note for Rs. 600. He pays Rs. 200 to the holder and the fact is noted on the instrument. The note can be negotiated for the balance of Rs. 400.

4. Restrictive Endorsement

It restricts the endorsee from further negotiating, the instrument or restricts the endorsee to deal with the instrument according to the direction of the endorser.

Example

Pay A only

Pay A for my use.

5. Conditional Endorsement

It limits or negatives the liability of the endorser. It is different from restrictive endorsement. It does not limit or negate the liability of the endorser. A conditional endorsement may be in any of the following forms.

(a) Sans recourse

In this case, the endorser excludes his own liability for dishonour of the instrument for the subsequent holder including the endorsee. However, the endorser 'Sans recourse' is liable to the previous endorsers.

Example: Pay to A or order without recourse to me.

(b) Facultative

If endorser either increases his liability or gives up some of his rights to by express words, the endorsement is called 'facultative endorsement'.

Example: Pay A or order. Notice of dishonour waived. It means, A has given up the right of receiving notice of dishonour.

(c) Sans frais

Where the endorser does not want the subsequent holder or endorsee of the instrument to incur any expense on his account on the instrument, the endorsement is called Sans frais.

(d) Liability depend on a contingency

The endorser may make the endorsement in such a way that his liability depends on happening of a certain event which may never happen. In case the event becomes impossible to happen, the liability of the endorsee will be at an end

Example: Pay A or order on his marriage with B.

In such cases the drawee must see that the instrument is paid to A or his order only when the specified event has happened. If payment is made otherwise, it can not be a payment in due course. The above condition will not effect the negotiability of the instrument.

16.13 MATERIAL ALTERATION

A Negotiable Instrument may be altered by the drawer or by a third party. The amount payable or date of the instrument may be changed. Alteration may be genuine or fradulent. It may be material or immaterial.

All changes which effect the business operation of the instrument is called Material Alteration.

Examples of Material Alteration

(1) Alteration in the date of the instrument.
(2) Alteration of the amount payable.
(3) Alteration in the date of the instrument.
(4) Alteration in the place of payment.
(5) Alteration in the rate of interest.
(6) Alteration of an order instrument into bearer instrument.

Examples of Non-Material Alteration

Alterations made before the issue of the instrument or made to carry out the intentions of the instrument as the parties will not effect the operation of the instrument as they are not material alterations. They are permitted under law. They do not effect the rights or liabilities of any party. They are:

(1) Alterations made with the consent of the parties.
(2) Alterations which are the result of an accident.
(3) Alterations made before the delivery of the instrument and so on.

According to Section of the Act, where a negotiable instrument has been materially altered but does not appear to have been so altered, payment thereof:

(a) by a person or banker liable to pay,
(b) paying the same in good faith and
(c) according to the apparent tenor thereof

and without negligence, shall discharge such person or banker from all liability thereon.

According to Sheldon, a banker can honour the cheques with alterations provided such alterations are confirmed by the drawer. If the alterations are insignificant, the banker cannot refuse payment. If a banker pays a cheque bearing unauthorised alterations, he cannot debit the drawer's account and is liable to the true owner.

16.14 SUMMARY

A Negotiable Instrument is a promissory note, bill of exchange or cheque payable to order. Negotiability, title, recovery, transferability etc. are its features are the characterstic features of Negotiable Instruments.

Section 4 of the Act defines a promissory note as, which contains a promise by the debtor to the creditor to pay a certain sum after a certain date.

Section 5 of the Act defines a bill of exchange. It contains an order from the creditor to the debtor, to pay a certain sum, to a certain person after a certain period.

The features of promissory note and a bill of exchange are: instrument in writing; un-conditional order or promise; drawn on a certain person; a certain sum of money; payee to be certain; payable on demand signed by the drawer or maker and delivery.

Section 6 of the Act defines a cheque. It is an order drawer on a specified banker to a pay a certain sum of money to a certain person. It is payable on demand always.

MICR cheques are used to speed up clearing of cheques.

Any material alteration should be evidenced by the signature of the drawer.

Holder means any person existed in his own name to the possession thereof and to receive or recover the amount due thereon from the parties there to.

Holder in due course is defined under section 9 of the Negotiable Instruments Act.

Crossing means drawing two transverse parallel lines across the face of the cheque either with or without the Words & Co.

A cheque may be a bearer cheque or a crossed. The various types of crossing are general, special, restrictive, double crossing etc.

Endorsement is defined u/s 15 of the Negotiable Instruments Act.

16.15 SELF ASSESSMENT QUESTIONS

1. Define a cheque, bill, promissory and a draft.
2. What is material alteration.
3. What is a negotiable instrument.
4. Define crossing.
5. Explain holder.

16.16 ESSAY QUESTIONS

1. Define crossing. What are the various types of crossing of cheques.
2. Define Endorsement. Explain the various types of Endorsement.
3. Explain the privileges of Holder in due course.
4. Differences between a B/E and a Promissory Note.

5. Differences between a B/E and a Cheque.

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DR. D. N. M. RAJU

Lesson 17

PAYING BANKER AND COLLECTING BANKER

17.0 OBJECTIVES

After the completion of this lesson we should be able to understand:

* Meaning of Paying banker and collecting banker.
* Precautions of a Paying banker while honouring cheques.
* When a paying banker can dishonour the cheques.
* Consequences of wrongful dishonour.
* Paying banker and crossed cheques.
* Protection to paying banker.
* Collecting banker as a Holder for value.
* Duties of collecting banker.
* Protection to collecting banker.

STRUCTURE

17.1 Introduction to Paying Banker

17.2 Precautions to be taken by a Paying Banker

17.3 Paying banker and Dishonour of Cheques

17.4 Consequences if wrongful dishonour

17.4.1 Paying banker and forged endorsement

17.4.2 Paying banker and crossed cheques

17.5 Protection to Paying Banker u/s 85

17.6 Essentials of Payment in due course

17.7 Meaning of Collecting Banker

17.7.1 Collecting Banker as Holder for value

17.7.2 Collecting Banker as agent

17.8 Duties of the Collecting Banker

17.9 Protection to Collecting Banker u/s 131

17.10 Banker's Negligence

17.11 Summary

17.12 Self Assessment Questions

17.13 Essay Questions

17.14 Refererence Books

17.1 INTRODUCTION

A banker has to make payment on a cheque drawn on him when it is presented. It is obligatory to honour the cheques by a banker under section 31 of the Negotiable Instruments Act. He has to honour the cheques of his customer as long as there is sufficient balance in the account. He has to take reasonable care in honouring cheques because any dishonour without reasonable cause make him liable of damages. At the same time he has to take reasonable care and see that the payments are not made even when there are no sufficient funds in the customer's account. The banker is not allowed to debit the customer's account later as it amounts to sanctioning of over draft without prior arrangement. It is because, the customer may take advantage this as a president in future also. That's how a paying banker's position is in between the devil and the deep sea.

17.2 PRECAUTIONS TO BE TAKEN

(A) The following precautions are to be taken by a paying banker on presentation of cheques for payment.

(1) Firstly, he has to see whether the cheque presented for payment is a bearer cheque or a crossed cheque. If it is a bearer cheque, cash is paid across the counter. If it is a crossed cheque, the payment is to be made to a fellow banker. In case of cheques crossed specially, the payment is to be made to the banker whose name is mentioned on the instrument. In case of account payee and Not-negotiable crossings, he is safe, as they are only the directions to the collecting banker. If he is negligent in the above cases, he is liable to the drawer and to the true owner.

(2) The banker should not make payments on the cheques drawer on the branch where the accounts are not maintained.

(3) Some time a customer may operate more than one account at the same branch. In such case, the banker should take care to make payment on cheques relating to that particular account only.

For example, a customer may have two accounts in the same branch. One account may be a current account and the other may be an over draft account. In such cases, the banker should not debit a current account for a cheque drawn on overdraft account and vice-versa. The same principle is observed in the case of "State Bank of India Vs Vathi Sambamurthy".

(4) The banker should make payments only during working hours of the bank. But during peak hours, the banker can make payments even outside banking hours for those who are waiting at cash counters.

The same principle is observed in the case of "Baines Vs National Provincial Bank".

(5) The banker should not make payment on a multilated cheque. Multiated cheque means a torn cheque. The banker should get confirmation from the drawer to make payment. However, if a

cheque is torn accidentally, the banker can obligue after getting written confirmation from the drawee.

(6) The banker should see that the cheques drawn are in proper form.

(7) The banker should see that the cheques drawn should not contain any condition.

(8) A cheque may be un-dated, post-dated or ante-dated. If it is undated, it is not valid. If it is ante-dated, payment can be made provided if it is presented within six months from the date of issue. If it is post-dated, it is to be honoured on the due date.

According to **Sir John Paget,** payments made on post-dated cheques amount to disobeying the customers mandate and authority.

(9) The amount mentioned in cards and figures must be the same, otherwise the paying banker should not make payment.

(10) The paying banker should not make payment on cheques with material alteration. Material alteration means any alternation which affects the business operation of the instrument. It may be inrespect of date, amount, signature etc. However, he can make payment if such alterations are ratified or confirmed by the drawer.

(11) The paying banker should verify the balance in account before honouring the cheques of his customer. He must take reasonable care before dishonouring cheques because the customers may have over-draft facility sometimes.

(12) The paying banker will not get protection under section 85 of the Indian Negotiable Instruments Acts inrespect of payments made on forged cheques. So, he must verify the signature of the drawer with the specimen signatures before making payment.

(13) He should not make payment when there is a Garnishee order.

(14) He must verify that the endorsements are regular before making payment.

Any failure or negligence of the paying banker in the above cases will land him in trouble.

17.3 DISHONOUR OF CHEQUES

A banker can dishonour the cheques under the following circumstances:

1. When there is no sufficient balance in the account of the customer.
2. When the funds available are not applicable to the payment of the cheque.
3. When the drawer makes a written request to the banker to countermand payment of the cheque.
4. When the banker notices any defect in the title of the person presenting the cheque.
5. When the banker has knowledge of the customer's death.

6. When the banker receives the notice of insanity of the customer.
7. When the customer is adjudicated as insolvent.
8. When the banker receives Garnishee order from the court.
9. When the banker receives the notice of assignment by his customer.
10. When the banker receives information of loss of cheque from the customer.
11. When the banker suspects that the customer is applying funds in breach of trust.
12. When the customer closes the account before the presentation of the cheque for payment.
13. When a post-dated cheque is presented before its ostensible date.

17.4 CONSEQUENCES OF WRONGFUL DISHONOUR

A banker has a statutory obligation under Negotiable Instruments Act to honour the cheques of his customer as long as the customer's account shows a positive balance. Sometimes, a banker may dishonour the cheques of his customer without any justification or out of negligence. In such cases, the banker has to compensate the customer for injury to his credit. The drawer of the cheque can claim compensation. The loss due to dishonour may not be monetary loss only but also loss of reputation. For traders loss of reputation is more important than monetary loss. The customer can claim substantial damages. But the customer must prove the damage caused to his credit.

The amount of compensation depends on the extent of damage caused to the customer's reputation. The damages are of two types. Generally, substantial damages are paid to the traders and nominal damages to the non-traders. Sometimes the traders may be awarded nominal damages and non-traders substantial damages. The awarding of damages can be understood clearly from the decided cases explained below.

Mrs. Gibbons is a non-trader. She is a customer of West Minister Bank Ltd. She issued a cheque to her land lord. The cheque is dishonoured wrongly. She is awarded £ 2 as nominal damages as she is only a non-trader.

In another case, Davidson is a trader. He is a customer of Barclays Bank Ltd. He issued a cheque. The Bank dishonoured the cheque wrongly. He is awarded £ 250 as damages. In this case the amount of damages paid is more than the amount of the cheque. The lesser the amount of the cheque dishonured the more is the damages paid as loss of goodwill will be severe.

17.4.1 Paying Banker and Forged Endorsement

Paying banker is protected under section 85 of the Act inrespect of payments made on cheques with forged endorsements. It is an exception to the general rule that 'forgery conveys no title'. So, a banker is not liable inrespect of payments made on cheques with forged endorsements. Under this section, when a cheque payable to order purports to be endorsed on behalf to the payee, the drawee is discharged by payment in due course. The person receiving the payment is liable to refund the amount to the true owner. In case of cheques payable to bearer is discharged by payment

in due course to the bearer is discharged by payment in due course to the bearer thereof. In such cases, the banker can ignore the endorsement. Where a banker refuses to honour cheques, then payments made by him are not payments in due course. He is not discharged from his liability to the true owner in such cases. Further, he can not ignore the irregularity in the endorsement. The banker can claim protection against the forgery of the signature of the endorser but not that of the signature of the drawer.

17.4.2 Paying Banker and Crossed Cheques

A paying banker gets protection in case of crossed if the payment is made in due course. In case of general crossing the payment is to be made to banker. In case of special crossing the payment is to be made to the banker to whom it is crossed. He should not make payment if the specially crossed cheques contain more than one banker. In no case, the banker can debit the drawer's account. Any act of the paying banker inviolation of the above rules is liable to the true owner.

The above, opinion is expressed in the case of Bobett Vs Pinkett.

17.5 PROTECTION TO THE PAYING BANKER (SEC 85)

It is the obligation of a banker to honour the cheques as long as the customers have positivebalances in their accounts. Sometimes, the signature of either the drawer or the endorser may be forged. The banker cannot debit the account of the customer in case of forged signature of the drawer. However, the banker is given protection under the Negotiable Instruments Act if the customer has acted negligently. It is because a Negotiable Instrument might have changed a number of hands before its due date. Cheque is a negotiable instrument. So, it is not possible for the banker to verify the genuiness of each signature as most of the endorsers are strangers and the banker will not have their specimen signatures with him as the endorsers may not be his customers.

It is a well known fact that Forgery conveys no title. In case of forged instruments even a holder in due course also cannot get better title. To protect the paying banker from the liability of forged endorsements, section 85 of the Negotiable Instruments Act provided certain exceptions.

Accordingly, "where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course". Thus, section 85 of the Act gives protection to the paying banker inrespect of payment made on order cheque with forged endorsement. However, the paying banker must satisfy two conditions to get protection under section 85.

They are:

(a) The endorsement must be regular and

(b) The payment must be made in due course.

The paying banker is also protected inrespect of crossed cheques under section 128 of Negotiable Instruments Act.

From above discussion, it is quite clear that a paying banker is protected only when he makes payment in due course. Payment in due course is defined under section 10 of the Negotiable Instruments Act.

According to section 10, "Payment in due course means payment in accordance with the apparent tenor of the instrument in good faith and with out negligence to any person in possession there of under circumstances which do not receive payment of the amount there in mentioned.

17.6 THE ESSENTIALS OF PAYMENT IN DUE COURSE

(1) Payment according to the apparent tenor of the cheques

The payment must be made according to the intentions and instructions of the parties concerned.

The following are **not** payments in due course.

(a) Payments made after due date.

(b) Payments made on post-dated cheques.

(c) Payment made on forged endorsement of payee.

(d) Payment made on crossed cheques across the counter.

(2) Good faith and without negligence

Good faith and reasonable care are essential to constitute payment in due course. The banker should make payment in good faith and without any negligence. Any dis-honest act is not an act of good faith. The banker cannot get protection in case of negligent payments. What is negligent and what is not negligent depends on the circumstances of the circumstances of the case. A clear cut acts of negligence can be: Payments made without verifying the regularity of endorsements, opening of an account without proper introduction etc can be some of the examples.

In the case of P.C. Bhandari Vs Punjab National Bank, the banker did not scrutinise the endorsement on draft. This act of the banker is decided as negligence in the above case. So, the payment made on draft is not regarded as payment in due course. The banker loses statutory protection under the Act, if payment is not paid in due course.

(3) Payment must have been made in the ordinary course of business

The banker loses protection if he makes payment against the existing rules and regulations of the bank and if the payment is not related to the ordinary course of business of the bank. The following are the examples of payments made not in ordinary course of banking business.

(a) Payments made outside the regular banking business.

(b) Payments made in large amounts on uncrossed cheques.

(c) Payments made on cheques with irregular endorsements.

(4) Payment to persons in possession of the instrument

The banker has to make payment to the correct persons. If a banker makes payment to a person who is not legally entitled to receive payment, it is not a payment in due course. The following are the examples of not payment in due course in the above circumstances.

(a) Payment made to a thief in possession of an instrument.

(b) Payment made without any confirmation from the drawer in case of suspicion.

(c) Payment made on a counter-manded cheque.

17.7 MEANING OF COLLECTING BANKER

It is not obligatory on the part of the banker to collect cheques of his customers. But, the banks perform this function to attract customers. In recent days, collection of cheques and bills of its customers has become an accepted part of banker's function. So, a banker who collects cheques and bills on behalf of its customers is called collecting banker. A collecting banker acts as a holder for value and as an agent of the customer in this process.

17.7.1 Collecting Banker as a Holder for Value

A collecting banker becomes a holder for value in the following cases.

(a) When he pays the cheque drawn on another bank, before it is collected.

(b) When he allows the customer to withdraw the amount of the cheque deposited before the cheque is cleared.

(c) Where he receives a cheque in specific reduction of the amount due from the customer and

(d) Where he has a lien on the cheque.

As a holder for value, he will be entitled to receive the amount of the cheque from the drawee in his own name. In case of dishonour, he can receive from one or all the endorsers. In case one of the endorsements is forged, he will be liable to the true owner. He can recover the amount form the endorsors subsequent to the forgery.

17.7.2 Collecting Banker as Agent

A banker is said to be an agent of the customer if he undertakes to collect the cheques of his customer without becoming a holder for value or a holder in due course. He must take care in acting as the agent of the customer. If he is negligent, he is liable to the customer for any loss that he may incur. If the cheque deposited for collection is dishonoured, the banker must inform the same to his customer. A collecting banker as agent cannot have a title better than the customer. He becomes liable for conversion if he collects a cheque with a defective title. However, he may be entitled for protection under section 131 of the Negotiable Instruments Act.

17.8 DUTIES OF THE COLLECTING BANKER

(1) Examination of cheques and endorsement

As an agent the collecting banker must take reasonable care in the collection of cheques. If the customer suffers any loss due to his negligent, he is liable to the extent of the loss suffered by the customer. If he does not take the precautions which a prudent banker would take, he is liable for damages.

It is observed in the case of Forman Vs Bank of England that as a collecting banker, he will not get a better title than his customer. In other words, if he collects a cheque of the customer with a defective title, he also will get only a defective title. In case of endorsements, he must verify their regularity.

(2) Presentment of cheques for collection

A collecting banker must present the cheques received within a reasonable time to the drawee bank. If the collecting and paying bankers are at one and the same place, the collecting banker may present the cheques on the following day. If they are at different places the cheques must be sent for collection on the following day. It is because the cheque will be dishonoured if the collecting banker fails to present the cheque within a reasonable time. The collecting banker can be held liable to compensate the loss suffered by the customer for his negligence.

(3) Information to the customer about collection

The collection banker must inform the customer about the amount collected and credited to his account. In the respect, he has to follow the instructions of his customer without fail.

(4) Notice of Dishonour

The collecting banker must give the notice of dishonour to the customer in case of dishonour. The dishonoured cheque must be returned to the customer with a covering letter. It helps the customer to recover the amount from the parties liable. If such notice of dishonour is not sent to the customer, the banker is liable for damages.

(5) Precautions to avoid conversion charge

It is the duty of the collecting banker to protect the interest of the owner of the cheque. The collecting banker can not get a better title if the customer is not the true owner of the cheque. So, a collecting banker is liable to the true owner on the charge of conversion if he collects a cheque of his customer without a title. The true owner can claim damages from the banker to the extent of the amount of the cheque. From above, it is clear that a collecting banker should take atmost care while collecting cheques of his customer.

17.9 STATUTORY PROTECTION TO THE COLLECTING BANKER U/S 131 OF THE NEGOTIABLE INSTRUMETNS ACT

A banker may collect cheques of his customer either as a holder for value or as an agent of the holder. As agent, he gets only the title of his customer. So, he is liable for conversion to the true owner in case, the banker collects a cheque of his customer having a defective title. The Act provides special protection to the collecting bankers against conversion.

Conversion is the unauthorised interference with the properly of third parties. If the customer has a defective title to the cheque, automatically, the collecting banker also will have only a defective title. In such a case, the collecting banker is held liable for the illegal interference with the rights of the true owner of the cheque. This is what is called 'conversion'. If this is so, no banker will oblligue to collect the cheques of his customers. So, the Act gives protection to him to facilitate collection of cheques.

Under section 131 of the Negotiable Instruments Act, the collecting banker is protected in case of receipt of money against a crossed cheque or a draft. If a collecting banker receives payment on behalf of his customer on cheques crossed either generally or specially without negligence and in good faith, he is not liable to the true owner even incases of cheques with defective title. It is because, he receives payment in good faith and without negligence. In short, the collecting banker is protected under the Act as long as he acts in good faith.

A collecting banker can claim protection u/s 131-A of the Act under the following circumstances:

(1) he must have collected a crossed cheque.

(2) he must have received payment not as a holder but as an agent.

(3) he must have received payment for a customer.

(4) he must have acted in good faith and without negligence.

17.10 BANKER'S NEGLIGENCE

It is difficult to define negligence. It depends on the facts of each case. A banker can not get protection under section 131 of the Act if he is negligent.

The following are the examples of Negligence

1. Opening a new account without proper introduction.
2. Failure to verify the regularity of endorsements.
3. Disregard of warnings on face of instrument.
4. Per-Pro Endorsements.

17.11 SUMMARY

It is the obligation of the banker to honour the cheques of his customer as long as there is

credit balance in the account. In case of wrongful dishonour of cheques, the banker is liable for damages. However, the banker can dishonour the cheques under certain circumstances. He is liable when he honours the cheques with forged signature of the drawer. The banker is not liable in case of forged endorsements. Statutory protection is given to the banker if he is not negligent. He is also given protection in respect of order cheques, crossed cheques and drafts.

Collecting banker is one who receives payment of a crossed cheque on behalf of his customer. A collecting banker will become holder for value in some cases. He gets only a defective title of the customer has defective title. He has certain duties as a collecting banker.

Conversion is unlawful interference with the property of another person which is inconsistent with the owner's possession.

Collecting banker is given protection u/s 131 of the Negotiable Instruments Act when he collects crossed cheques. He is protected even inrespect of forged endorsement. To get protection he should act in good faith and without negligence. Opening of an account without proper introduction, failure to verify the regularity of endorsements etc are the examples of negligence of a banker.

17.12 SELF ASSESSMENT QUESTIONS

1. Forged endorsement
2. Crossed cheques
3. Garnishee order
4. Paying banker
5. Collecting banker
6. Collecting banker as agent
7. Holder for value

17.13 ESSAY QUESTIONS

1. What are the duties and responsibilities of a paying banker?
2. What are the precautions to be taken by a banker in honouring cheques?
3. What are precautions to be taken by a paying banker incase of crossed cheques?
4. Explain the statutory protection given u/s 85 of the Act.
5. What are the responsibilities of a collecting banker?
6. Explain the statutory protection given to paying banker.

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Dr. D. N. M. Raju

Lesson 18

LOANS AND ADVANCES I
Secured Advances

18.0 Objectives:

The main purpose of this lesson is to help you to:

- understand the importance of bank loans and advances
- learn the principles of bank lending
- know various methods of bank lending
- analyse various forms of securities that a banker secures while advancing

Structure:

18.1 Introduction
18.2 Principles of bank lending
18.2.1 Liquidity
18.2.2 Profitability
18.2.3 Safety and Security
18.2.4 Purpose
18.2.5 Social responsibility
18.2.6 Industrial and Geographical diversification
18.3 Methods of granting advances
18.3.1 Cash credits
18.3.2 Overdrafts
18.3.3 Bills discounting
18.3.4 Issue of letters of credit
18.3.5 Loans
18.4 Secured Advances
18.4.1 Guidelines for secured advances
18.5 Forms of Securities
18.5.1 Lien
18.5.2 Pledge
18.5.3 Mortgage
18.5.4 Hypothecation
18.6 Summary
18.7 Key words
18.8 Self Assessment Questions
18.9 Suggested Readings

18.1 Introduction:

A banker borrows money from the public in the way of deposits and lend to them as loans and advances. While lending, the banker should follow that investment policy which should bring maximum profits to the shareholders and provide maximum safety and security to the depositors. It is not easy to a banker in deciding to whom these deposits are given as advances. It requires skill and care. Generally, the loans and advances are influenced by the local conditions where the bank operates. For example, in India, conditions differ in rural and urban areas and these differences have their impact on the investment policy of the banker. Similarly, investment policies of bankers differ widely from country to country as the nature of money and capital markets differs in every country. Therefore, while investing, the banker should be more careful and follow sound investment policy. For a sound investment policy the banker should follow certain principles. Let us discuss about them in detail.

18.2 Principles of bank lending:

The following are the principles; generally a banker should follow while lending. Depending on the situation, the banker can follow one or more of the principles.

18.2.1 Liquidity:

The term 'liquidity' means the capacity of the banker to pay cash on demand in exchange of deposits. According to Sayers "Liquidity is the word which the banker uses to describe his ability to satisfy demand for cash in exchange of deposits". A large part of the deposits received by the banker is in the form of demand deposits, which are withdraw able without any notice. Therefore, the banker must maintain sufficient amount of funds every time to meet the demands of the customers. If he fails to do so, he will suffer in his credit, which is very foundation of his business. Contrary to it, if a banker keeps most of his funds in th form of cash, he may not earn any income as cash is an idle asset. Therefore, banker should invest money in those assets, which are highly liquid and can be converted into cash without any loss of value. If this is done, the banker will be able to meet the demand of his depositors at all times and in addition, he will earn some income. So it is advisable for a banker to maintain a sufficient degree of liquidity in his assets.

A banker can maintain liquidity in his assets when he employs funds in liquid assets. A liquid asset can be converted into cash quickly and without any loss. The banker can pay his depositors in full only when his assets are sold without loss. Therefore, banker must be able to convert his assets into cash quickly and without loss.

Liquidity and Solvency: The concept of liquidity is different from solvency. If a banker is able to meet his debt obligations, he is said to be solvent. This is the situation where his assets value is more than his liabilities value. But a banker is said to maintain liquidity when his assets can be converted into cash quickly and without loss. Thus, a banker may be solvent but may not be liquid. More solvencies may not guarantee liquidity.

Liquidity depends on th shift ability without loss. In this sense, advances granted by a banker by way of discounting first class bills of exchange satisfy this principle. The central bank of India extends rediscounting facilities to first class bills, and this enables the banker to obtain

funds in case of emergencies. In other cases, shift ability may not be possible. However, wherever possible, the banker can insist on securities, which are shift able without loss.

18.2.2 Profitability:

Banks, no doubt, are business organizations. They have to earn sufficient profits to meet all its expenses and pay a fair percentage of dividends to their shareholders. The profits of the banks will be higher if the yield from the assets is greater. The banks should determine the portfolio in such a way that they are able to derive maximum profits. Therefore, banks should invest funds in those securities, which give higher yields. However, the profits must be justifiable. Excessive and unjustifiable profits can only be at the cost of the customer and ultimately the society n general will be affected.

Liquidity and profitability: Liquidity and profitability are two conflicting aspects. Liquidity can be obtained at the cost of profitability and profitability can be achieved at the cost of liquidity. For example, cash, a liquid asset earns nothing. Contrary to this, loans and advances earn higher income and have less liquidity. Thus, conflict between these two concepts continues to exist. Therefore, bank should always try to reconcile these two considerations. Both these are essential to any bank. Hence forth, the bank should keep adequate cash reserves or near cash asserts to meet the day- to-day requirements of the depositors and invest the balance in profit-earning assets.

18.2.3 Safety and Security:

The third important principle that a banker should follow while lending is the safety and security of investments. As the banker is advancing public money, he should not afford to invest bank funds in rids adventures even though they may earn higher incomes. Before granting a secured advance, the banker should carefully consider the margin of safety offered by the security concerned and possibilities of fluctuations in its value. If it is an unsecured advance, its repayment depends on the creditworthiness of the borrower, and the guarantor wherever applicable.

18.2.4 Purpose:

While granting loans banker should be careful of using such loans by the customers. Sometimes, after sanction customers may divert loans pro other or unproductive purposes. This may hamper timely repayment. Therefore, proper steps are required for effective post credit supervision.

18.2.5 Social Responsibility:

Though banks are business organizations, they cannot escape from their social responsibilities. Technical competence of the borrower, operational flexibility and economic viability of the project should be given priority while evaluating the loan proposal rather than security offered by the borrowed. Similarly, banks should give priority-to-priority sector while lending loans. However, this social responsibility should not come in the way to the banks from paying adequate attention to the qualitative aspects of lending.

18.2.6 Industrial and Geographical diversification:

The banker should distribute advances to wider areas covering many industrial and geographical locations. Giving advances to few industries, at few places may hamper the interest

of the bank in case of unanticipated factors. Further, distribution of loans to wider spectrum helps in balanced regional development of the country.

While considering a proposal for an advance, the banker is required judiciously blend all the above principles, and no principle is considered in isolation.

18.3 Methods of granting advances:

The following are the five methods of granting advances:

1. Cash credits
2. Overdrafts
3. Bills discounting
4. Issue of letters of credit
5. Loans

18.3.1 Cash credits:

Cash credit is an important method of lending for banks. More than 50% of bank lending comes under this method. A cash credit is an arrangement under which a borrower is allowed to borrow up to a certain limit known as 'cash credit limit' against the security of tangible assets or guarantees. The borrower can avail the amount within that limit in one installment or many times. Even he can avail only a part of it according to his requirements. The bank charges interest for the amount availed by the borrower. Borrower can also credit any surplus cash with him. From the banker's point of view, it is a loss to the banker in the form of interest on the unavailed portion of cash credit; as the total limit is kept available to the borrower. To compensate this, generally banker incorporates 'minimum interest clause' in the agreement. This facilitates a minimum rate of interest to the banker on the unavailed portion of the cash credit.

18.3.2 Overdrafts:

This method of granting advances has similarities with that of cash credit. Here, a customer has to open a current account. He will be allowed to overdraw up to a certain limit as per the agreement reached. Any businessman can enter into this type of agreement to overcome temporary shortage of funds. Unlike cash credit where minimum interest clause exists, in overdraft facility interest will be charged on the overdrawn amount only. Generally, at the end of the financial year, the borrower has to wipe of debit balance in the current account. Thus, overdraft is a short-term credit facility, whereas, cash credit is a little long-period accommodation. The bank may take some tangible security against such facility or may grant such limit on the personal security of the borrower. The borrower can draw the amount as and when he requires and repay it when it is convenient for him.

Banks are giving now-a-days overdraft facility even for savings bank customers. Generally, a minimum amount of overdraft on personal assurance is being provided for regular and sincere customers.

18.3.3 Bills discounting and purchasing:

Bills discounting method of granting advances is also a short-term facility. Banker discounts bills of exchange of his customer and provides him advance. On the face value of the bill certain

percentage is deducted as discount. This method is highly favoured by conservative bankers according to whom the earning assets of a bank should consist mainly of short-term self-liquidating productive loans. A genuine commercial bill of exchange is a self-liquidating paper as it liquidates automatically out of the sale of the goods covered by such a bill.

Sometimes, banks purchase bills at their face value less bank charges and advance money. Purchases of bills are normally confined to bills payable on demand.

18.3.4 Issue of letters of credit:

A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document to the extent of a stated amount in the letter and charge the same to the account of the grantor of the letter of credit. This letter is a promise made by the issuing banker to the other banker on behalf of its customer up to the sanctioned limit of credit. Trade between countries is financed mainly through this method. Generally, the bank issues letter of credit based on the credit worthiness of his customer.

18.3.5 Loans:

When a bank makes an advance to its customer who undertakes to repay it in one single installment, is called a loan. Here, the borrower is required to pay the interest on the total loan amount from the date of sanction, whether he draws the full amount from the loan account or not. Normally, the rate of interest on loans is higher than cash credits and overdrafts. In some cases bank may also allow the borrower to repay the loan in installments. As far as the bank is concerned, the operating cost of a loan is lower as compared to a cash credit or an overdraft.

Loans Vs. Cash credits: If once loan is sanctioned, to a borrower the interest is charged on the entire amount and a loan once repaid on full or in part cannot be drawn again. The borrower has to apply for a fresh loan if he needs funds. The second transaction will be totally different from the first one. But a cash credit is of a continuing nature, i.e., money can be withdrawn or paid into the credit and interest will be charged only on the actual credit. Thus, raising funds through loan is costlier to the customer than of cash credits.

18.4 Secured Advances:

Advances occupy important place in the balance sheet of any commercial bank. Advances include cash credits, overdrafts and loans as discussed in the previous pages. Advances may be secured or unsecured.

Banks give advances to its customers if they have good reputation and sound financial position. They may be granted loan or allowed an overdraft by the bank on personal security. Such advances are known as clean or unsecured advances and are granted against the promissory note of the borrower. But in order to safeguard its position, the bank may insist for sureties or guarantors.

Unsecured advances are risky. Bank has to rely completely on the integrity, reputation and character of the borrower. While granting clean credit, the bank should be very cautious as to the character and capacity of the borrower. The borrower should have the required ability, competence and experience to invest the credit judiciously and earn profits to pay back the loan. If the bank fails to understand the customer properly, the unsecured loans turn to be bad debts.

Secured advances : are those advances, which are granted against some tangible securities apart from the promissory note of the borrower. According to Sec. 5(i) (n) of the Banking Regulation 'Act, " Secured loan or advance means a loan or advance make on the security of assets, the market value of which is not at any time less than the amount of such loan or advance". Thus, a secured advance must have cent percent backing of tangible and marketable assets as security. The securities against advances are also known as " collaterals" (additional) as they are offered in addition to the personal security of the borrower. A collateral security may take the form of a lien, or a pledge or a mortgage. We will discuss about these later.

18.4.1 Guidelines for secured advances:

Banks generally lent to the individuals and organizations in the form of secured advances. Even then many risks are involved in getting back the amount with the agreed interest. In order to avoid risks, banks have to follow certain principles or guidelines. The most important among them are liquidity, profitability and safety and security. These are discussed earlier. Some additional guidelines are given here to the banker while granting secured advances.

1. Credit-worthiness of the borrower: The basic principle on which credit is based is the credit-worthiness of the borrower. It depends on the reliability, responsibility and resources of the borrower. The bank should give loan to a reliable and responsible person and have intention to repay the loan. Further, he must have sufficient resources. He must be in a position to bear any risk that occurred in the organization.
2. Financial position of the borrower: The bank should examine the financial position of the proposed borrower. It should verify his organization's financial statements of the last few years. This will help the bank to know the nature of the business and liquidity of the position of the assets etc. Sound financial position of borrower is necessary to get back the loan amount in full.
3. Amount and period of loan: A bank cannot grant big loans to few individuals or concerns and similarly, for longer durations. Because a major portion of its deposits represents demand deposits which are repayable on demand. Therefore, bank should consider the period of loan and amount of sanction carefully before hand.
4. Security: The bank should also study the nature of security offered for the advance. The offered security should be easily marketable and stable in value. Bank should keep adequate margins in case of fluctuating securities. The margins should also be sufficient to cover the cost of realizing the asset and the interest charges in case of default by the borrower. While accepting securities all legal formalities should be followed.

18.5 Forms of Securities:

A banker lends secured advance to a borrower on some collateral security. These securities are tangible in nature. However, a security of tangible in nature is of no use unless it is properly charged in favour of the bank. Banker can recover the loan in case of default by the borrower by disposing of the securities only if they are properly charged in favcour of the bank. The charge must be registered with appropriate authorities wherever required; otherwise bank may lose its right on those securities. In this view, a banker can secure the advances in the following forms:

1.Lien
2. Pledge
3. Mortgage
5. Hypothecation

18.5.1 Lien

A banker's lien is a 'general lien', which confers a right to retain properties in respect of any general balance due by the debtor to the banker. Right of lien entitles the banker to retain the property or security belonging to the debtor till the payment of debt. Another type of lien called 'particular lien' confers a right to retain that property for which the amount is to be paid. Section 171 of the Indian Contract Act confers the right of general lien on the bankers. Bankers can have lien not only on the securities like cheques and bills of exchange, but also on goods coming into their possession unless there is a contract to the contrary.

Features of banker's lien: The following are the special features of banker's lien.

1. The banker possesses the right of general lien on all the securities and goods entrusted to him in his capacity as banker.
2. A general lien is an implied pledge, which gives him a right to dispose of the goods in due course to realize his dues. Thus, a banker's right of lien is more than general lien (general lien allows to retain goods and not to sell them).
3. A banker can exercise his right of general lien only on those goods and amount in balance, which stands, in the name of the borrower.

Exceptions to the right of lien: The right of lien of the banker has the following exceptions:

1. **Articles for safe custody:** Sometimes, a customer deposits his valuables with banker for safe custody. In such cases, the banker cannot exercise his right of lien.
2. **Documents left for a specific purpose:** When a customer sends a cheque or a bill of exchange with the clear instruction to utilize its proceeds for a specific purpose, the banker cannot exercise his right of lien on the proceeds of such cheque or bill of exchange.
3. **Securities left negligently:** When some securities or documents are left with the banker by mistake or negligently, he cannot exercise the right of lien over such securities or documents.

18.5.2 Pledge:

According to Sec.172 of the Indian Contract Act, 1872 'pledge is the bailment of goods as security for the payment of a debt or performance of a promise'. Under pledge, banker takes the possession of goods of the customer. As pledge is a special kind of bailment it has the following features:

1. Pledger (customer) should deliver goods to the pledgee (banker). The delivery of the pledgee may be actual or constructive. Delivery of the key of the warehouse where pledged goods are kept is a constructive delivery and is sufficient to create a pledge. The ownership of the goods pledged remains with the pledger.
2. Pledge can be made only of movable properties.
3. A contract of pledge must be supported by a valid consideration. The goods should be offered as security for the payment of a debt or the performance of promise.

Pledge Vs. Lien: The following are the differences between pledge and lien.

Pledge	Lien
1. It is always created by a contract	1. It is not created by a contract. In most cases, it is created by law.
2. The pledgee has a right to sell the goods in his Possession on the default by the debtor right to sell goods. But banker pledge) informing the customer	2. The party in possession of goodsdoes not have in general any can do so as it is an implied and gibing sufficient time.
3. It is not necessarily terminated by return of goods to the owner. The goods pledged may be the redelivered to the pledger for a limited Purpose.	3. Right of lien lost with the loss of possession of goods.
4. It enjoys the right to sue, right of sale and the right of lien.	4 . It is a passive right. Lien holder Can only hold the goods till the payment is made. Lien holder(banker-an exception) cannot enforce its calim through a court of law.

Rights and duties of banker as pledgee:

The following are the rights of banker as a pledgee:

1. **Right of retainer:** The banker has a right to retain possession of the goods pledged with him till the customer pays not only the debt but also interest thereon, and all expenses incurred in respect of the possession or the preservation of the goods pledged.
2. **Right of particular lien:** Banker cannot retain the goods for any debt other than that for which the pledge was made. But in the absence of anything to the contrary, he can retain the goods pledged for the subsequent advances.
3. **Right to extra-ordinary expenses:** Section 175 of the Indian Contract Act entitles the banker (pledgee) to recover from the customer (pledger) extra-ordinary expenses incurred by him for the preservation of the goods pledged.
4. **Right in case of default of the customer:** If a customer fails to pay the debt within the stipulated period, banker, as per section 176 of the Indian Contract Act, has a right to sell the goods pledged after giving reasonable notice of sale to the customer.

The following are the duties and obligations of banker as a pledgee:

1. Banker has to take reasonable care of the goods pledged with him.
2. He has to return or deliver the goods without loss or destruction to the customer after he clears his debt.
3. Banker is not allowed to use the pledge goods, and if he does so he will be responsible for any loss or damage.
4. The banker has to deliver the goods to the customer or anyone whom he directs.

18.5.3 Morta

When a borrower offers his immovable property like building, land, factory premises etc., for a loan a charge thereon is created by means of a mortage. Mortgage is a type of contract. The borrower is called the mortgagor and the lender is known as mortgagee.

As the next lesson deals with the immovable property alone, we will disscuss there about this concept in detail.

Mortgage Vs. Pledge:

In case of pledge, the possession of goods is with the creditor or the pledgee, whereas in mortgage, the immovable goods remain with the mortgagor. Delivery of possession is essential in a pledge, but the pledgee has only a special interest in the property and the general interest remains with the pledger. Goods are movable in case of pledge but mortgage is possible only in the case of specific immovable property.

18.5.4 Hypothecation:

Hypothecation is a mode of securing a loan by creating a charge on movable goods without surrender of possession or ownership. In other words, mortgage of movable property without transfer of ownership or possession is called hypothecation. Thus, the borrower continues to the owner of the property hypothecated as in the case of pledge. But the possession is not transferred to the creditor or the lender.

In hypothecation, the charge created is equitable. Under this arrangement, the movable property remains in the possession of the borrower who undertakes to give the possession of the creditor when the latter requires him to do so. Thus, charge of hypothecation can be converted into a pledge by the lender at any time. In such a case, the lender enjoys all the rights of a pledgee.

Hypothecation is the most suitable arrangement in circumstances where the transfer of possession of the goods is either inconvenient or impracticable. For example, a lorry transporter provides the security of his lorries for a loan, transfer of possession will hamper his business. This difficulty can be removed by hypothecating the assets with the bank. This enables the borrower to utilize his lorries in the ordinary course of his business. Thus, hypothecation is a floating charge on the borrower’s assets.

Hypothecation Vs. Pledge:

In hypothecation goods are not transferred to the creditor. The debtor continues to enjoy the possession of goods and has a right to deal with them subject to the terms of contract. But in pledge, the debtor transfers the possession of the property to the creditor and thus loses the right to deal with the property pledged. The charge of hypothecation can be converted into pledge at any time by the lender or the creditor.

Risks of Hypothecation:

As the goods remain in the possession of the borrower, the facility of hypothecation should be given only to honest persons, otherwise bank may suffer. The following are the other risks associated with hypothecation.

1. When goods are with the borrower, the banker may not have effective control over the goods.
2. The borrower may sell the goods.
3. The borrower may hypothecates or pledge the same goods to other lender.
4. The borrower may not deliver the hypothecated goods when required by the bank.
5. When borrower damages or spoils the goods, the hypothecation becomes useless.

Precautions to be taken by the banker:

In view of the risks involved in the creation of charge by hypothecation, banker should take the following precautions:

1. Banker should grant advances on hypothecation to persons of high integrity and business morality.
2. Banker should ensure that the goods hypothecated should not be hypothecated earlier at any lender. To this effect, an undertaking from the borrower is better.
3. The banker should check the hypothecated goods often through a responsible officer.
4. The banker should see that the borrower displays a board of hypothecation on or near the hypothecated goods.
5. Properly insured goods should only be hypothecated.
6. In case of an advance to a joint stock company, the bank's charge under hypothecation must be registered with the Registrar of Companies under Sec.124 of the Companies Act within 30 days of its creation.

18.6 Summary:

Loans and Advances occupy important place in bank's lending. A banker has to follow principles like liquidity, profitability, safety and security etc., while lending. Otherwise, he cannot get back the amount properly. Cash credits, overdrafts, bills discounting, issue of letters of credit and loans are various methods of granting advance. While granting secured advances, in addition to liquidity profitability and safety and security banker should follow some more guidelines like creditworthiness and financial position of the borrower, amount and period of loan and security. Banker lends secured advance to the borrower in various forms viz., lien, pledge, mortgage and hypothecation.

18.7 Key words:

Liquidity — The capacity of the banker to pay cash on demand in exchange of deposits.
Cash credit — An arrangement under which a borrower is allowed to borrow Up to certain limit.
Overdraft — An arrangement under which a borrower is allowed to overdraw from his account up to a certain limit.
Letter of credit — A document issued by a banker, authorizing some other Bank to honour the cheques of a person named in the Document to the extent of a stated amount.
General lien — Right of the banker to retain the property of the debtor till the payment of debt.
Pledge — Bailment of goods as security for the payment of debt or performance of a promise.

Hypothecation — A mode of securing loan by creating a charge on movable goods without surrender of possession or ownership.

18.8 Self Assessment Questions:

Short Questions:

1. What is liquidity?
2. What is a cash credit?
3. What is a lien?
4. What is hypothecation?

Small Questions:

1. Distinguish between liquidity and profitability.
2. What are the differences between lien and pledge?
3. What are the rights of banker as a pledgee?
4. Explain the risks in hypothecation.

Essay Questions:

1. Write about various principles of bank lending.
2. Discuss various methods of granting advances.
3. Bring out different forms of securities a banker can secure while lending advances.

18.9 Suggested Readings:

1. Banking Theory and Practice – K.C. Shekhar and Lekshmy Shekhar
2. Banking Theory and Practice—P.K. Srivastava

Dr. R. Jaya Prakash Reddy

Lesson 19

Loans and Advances II

Types of securities – Goods and Immovable property

19.0 Objectives: The main purpose of this lesson is to help you to:

— Study various types of securities
— Understand pros and cons of goods as security
— Learn various aspects of loan on immovable property
— Analyse the concept of mortgage of immovable property

Structure:

19.1 Introduction

19.2 Types of securities

19.2.1 Goods

19.2.2 Immovable property

19.2.2.1 Mortgage

19.2.2.1.1 Types of Mortgages

19.2.2.1.2 Advantages

19.2.2.1.3 Disadvantages

19.2.2.1.4 Rights

19.2.3 Life insurance policies

19.2.4 Fixed deposit receipts (FDRs)

19.2.5 Stock exchange securities (S.E.Ss)

19.2.5.1 Advantages of advances against S.E.Ss

19.2.5.2 Risks involved in advancing against S.E.Ss

19.2.5.3 Precautions to be taken while advancing against S.E.Ss

19.2.6 Advances against real estates

19.2.6.1 Difficulties in dealing with real estates

19.2.6.2 Precautions to be taken while advancing against real estates

19.2.7 Advances against book debts

19.2.7.1 Precautions required in advancing loans against book debts

19.2.8 Advances against documents of title to goods

19.2.8.1 Risks of documentary credit

19.3 Summary

19.4 Key words

19.5 Self Assessment Questions

19.6 Suggested Readings

19.1 Introduction:

Banker lends loans and advances to the borrower keeping with him various types of collateral securities. In this lesson, we will discuss different types of securities and their related aspects. While discussing immovable property as security the important related aspect of mortgage will be discussed at length. However, securities of life insurance policies and fixed deposit receipts (FDRs) will be discussed in the next lesson in detail.

19.2 Types of securities:

The survival of any bank mainly depends on the safety and security of its assets, particularly loans and advances. Therefore, while lending a prudent banker should ensure that advances given to the borrowers are backed by sufficient collateral securities. These securities must be tangible and easily marketable so that the banker may sell them to realize the debt in case of default by the borrower. The important securities that are lodged for securing advances are as under:

1. Goods
2. Immovable property
3. Life insurance policies
4. Fixed deposit receipts
5. Stock exchange securities
6. Real estates
7. Book debts
8. Title deeds of goods

19.2.1 Goods:

According to Sec. 2(7) of Sale of Goods Act, 1930 'goods' means every kind of movable property other than actionable claims and money, and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.

This definition covers agricultural products like rice, wheat, tobacco, cotton, Jute, mirch etc., industrial raw materials and finished products, plantation products, mining products etc. The basic characteristic of any 'goods' is movable. Banker normally accepts foods as security as they are easily marketable. However, there are certain disadvantages regarding this item. Let us discuss about its advantages and disadvantages in the banker's point of view.

Advantages:

1. Goods are a better security than guarantees as they offer tangibility. If a borrower fails to pay back the loan taken, the banker can sell the goods and recover the due amount along with interest.
2. Goods can be marketed easily. As and when a borrower expresses his inability to pay back the loan, the banker can sell his goods and get back the dues. Some commodities like oils and closes have international markets, selling such goods become easier.
3. The prices of certain essential goods like rice, wheat etc., do not fluctuate widely and such goods have steady market values.

4. Valuation of goods is easy. Based on the market price and keeping sufficient margin banker can arrive at the amount of sanction.
5. Normally, advances on goods are short-term in nature. The borrower pays back the loan amount immediately after the goods are processed or sold.

Disadvantages:

1. Banker may not be an expert in judging the quality of all types of goods. A fraudulent borrower may mislead the banker and get loan more than the value of the security.
2. Certain goods lose quality and value with the passage of time. Fruits and vegetables perish within a short period, rubber shrinks and loses weight if stored for a long time, food grains are liable to be damaged by while ants, rats etc. In this sense, these goods are not good securities.
3. The prices of certain goods widely. Banker may be put into trouble in the prices of goods come down very steeply.
4. Banker may face difficulty in valuing certain goods, which have many varieties. He may not be well versed with all varieties and all types of goods in the market.

Precautions to be taken by the banker:

Banker should take the following precautions while advancing loans against goods as security.

1. While advancing loans against goods, the banker should also see the credit worthiness and trust worthiness of the borrower.
2. The banker should accept such commodities, which can easily be marketable.
3. Ownership of the goods should be checked before keeping them as security.
4. Proper enquiry in the market about the quality etc., should be made against the goods which are going to be kept as security.
5. The banker should take the actual or constructive delivery of the goods depending upon the integrity of the borrower.
6. The banker should see that the goods are insured against fire and theft for full value. They should be kept in proper place to avoid any loss or damage.
7. If the possession of goods is not possible, it is better to have an hypothecation agreement with the borrower.
8. Sufficient margins are to be maintained on all goods depending upon the credit worthiness of the borrower, prices, market demand etc.
9. Goods kept, as a responsible officer of the bank should inspect security regularly. If certain amounts of goods are to be released to the borrower, the banker should check the balance loan amount and the value of goods very carefully.

19.2.2 Immovable property:

Banker advances not only on movable property but also on immovable property. Land and buildings, plant and machinery etc., come under this category. When a borrower offers his immovable property for a loan, a charge thereon is created by means of mortgage. Therefore, let us discuss about mortgage in detail.

19.2.2.1 Mortgage:

According to Sec. 58 of the Transfer of Property Act, 1882, mortgage is defined as "the transfer of an interest in the specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt or the performance of an agreement which may give rise to the pecuniary liability". Thus, mortgage is a type of contract. The borrower is called the mortgagor and the lender or the banker with whom the property is mortgaged is mown as mortgagee. The document with mortgage terms is called the mortgage deed.

In mortgage, owner of the property or the borrower transfers interest in an immovable property. It means, he transfers only some part of his rights over the property and kept the remaining with him. It is different from sale, where all rights are transferred to the buyer. Further, property mortgaged should be specific one i.e. it can be clearly identified and described. In addition, mortgage property must be supported by a lawful consideration i.e. either money advanced or to be advanced by way of a loan or the performance of a contract.

19.2.2.1.1 Types of Mortgages:

There are six types of mortgages. They are as follows:

1. Simple mortgage
2. Mortgage by conditional sale
3. Usufructuary mortgage
4. English mortgage
5. Equitable mortgage
6. Anomalous mortgage

1.Simple mortgage: Under this mortgage the borrower does not handover the mortgaged property to the banker but bind himself personally to pay the mortgage amount. However, he agrees to handover the mortgage property for sale to the banker if in any case fails to pay the due amount.

2. Mortgage by conditional sale: Under this type the mortgagor virtually sells the property to the mortgagee (banker) on certain conditions. Such sale will become absolute only if the mortgage debt is not repaid on a certain date and the mortgagee gets a decree from a court. The mortgagee can apply to the court for foreclosure of the mortgage and not for sale. By foreclosure the mortgagor loses right on the mortgaged property. Banker usually does not prefer this type of mortgage because there is no personal commitment for the repayment of debt.

3. Usufructuary mortgage: In this type of mortgage, the mortgagor delivers the possession expressly or by implication and binds himself to deliver the mortgaged property to the mortgagee. Further, he authorizes the mortgagee to retain such possession until payment is made and receive the rents and profits accruing from the property.

Banker does not like this type of mortgage because there is also no personal commitment to repay the debt and the debt has to be recovered by appropriating rent and /or profits, which will take a very long time.

4. English mortgage: Under this type the mortgagor binds himself to repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee, but subject to the condition that he will re-transfer it to the mortgagor upon payment of the mortgage money as agreed.

5.Equitable mortgage: Under this mortgage the mortgagor keep documents of title to immovable property with the mortgagee. Under Sec. 58 (f) of the Transfer of Property Act, such a mortgage can be created in the cities of mumbai, kolkata and Chennai and in any other city specified by notification in the official Gazette by the state governments.

6.Anomalous mortgage: This is a mortgage other than those explained above. It includes the customary mortgage under which the rights and liabilities of the parties are determined by the local custom or the contract between them.

Legal mortgage Vs. Equitable mortgage:

A legal mortgage is one in which the mortgagor transfers his legal title in respect of the mortgaged property to the mortgagee. This is affected only by a registration. When the mortgage money is paid off, the title in the property is retransferred to the mortgagor.
In equitable mortgage the martgagor delivers to the mortgagee documents of title to the immovable property with the intention to create a security only. Thus, legal title is not transferred to the mortgaee at the time of the contract.

19.2.2.1.2 Advantages of equitable mortgage:

The following are the various advantages of equitable mortgage.

1. As there is no registration under this mortgage, the mortgagor can save registration charges and time to complete different formalities.
2. As there is no registration, the reputation of the mortgagor cannot be affected.
3. Equitable mortgage can be completed without much delay unlike legal mortgage where much time is wasted in filling up formalities.
4. When the mortgagor repays loan, he can take back the title deeds and resubmit for another loan immediately if he so desires. But in case of legal mortgage it takes lot time for registration and re-registration procedures.
5. As both legal and equitable mortgages are on the same footing and come under Sec. 96 of the Transfer of Property Act with same rights, equitable mortgage looks and works better.

19.2.2.1.3 Disadvantages of equitable mortgage:

1.In case of default of the motgagor, the mortgagee has to go to the court and get decree to sell the property, which is a costly, and time consuming matter. In case of legal mortgage the mortgagee has the right to sell the property with out approaching the court.

2.Mortgagee does not have direct control over the property of the mortgagor under equitable mortgage.

From the above discussion we can say that legal mortgage is better than the equitable mortgage as the latter is registered I in the name of the banker and he can sell the property mortgaged without following any formality in case of default of the mortgagor.

19.2.2.1.4 Rights of a banker or the mortgagee:

The rights of a banker as the mortgagee have the following rights against the mortgagor.

1. In case of mortgage by conditional sale, the mortgagee has the right of foreclosure and gets a decree from a court of law and will become the owner of the property.
2. The mortgagee has a right to sue for the mortgage money as the mortgagor has undertaken personally to pay the amount in case of simple mortgage.
3. The mortgagee has the right to sell the property in the event of fault by the mortgagor in case of English mortgage, where the right of sale is given expressly by the mortgage deed.
4. A legal martgagee can also take possession of the mortgaged property in the event of default by the borrower or the mortgagor.

19.2.3 Life insurance policies X These two aspects will be discussed in the
19.2.4 Fixed deposit receipts (FDRs) X next lesson

19.2.5 Stock Exchange Securities:

Stock exchange securities include all securities (equity shares, preference shares, debentures etc.,) issued by public and private enterprises, public authorities and governments. Bankers generally consider stock exchange securities as acceptable securities for loans and advances. In case of necessity, such securities can be realized without much difficulty, and most of their value can be ascertained through stock exchanges. Further, some securities are fully negotiable.

The valuation of stock exchange securities depends on the category to which they belong. Generally securities issued by governments and semi-government bodies are ranked first to that of securities issued by industrial and commercial enterprises.

19.2.5.1 Advantages of advances against stock exchange securities:

1. Stock exchange securities are better securities than a simple guarantee. Securities are treated as tangible assets even though they are paper documents. When a borrower fails to pay the debt, the banker can sell the securities in the market to recover the debt.
2. These securities can be marketed easily as they have wide and ready market. Stock exchanges help in selling and buying of all kinds of listed securities.
3. As securities are easily marketable, they are highly liquid. Banker can get cash by selling securities. Further, securities, particularly issued by governments can be pledged with Reserve Bank of India for the purpose of accommodation.
4. When compared to agricultural produce the fluctuations in securities prices are less. Particularly, fluctuations in government securities are minimal. So the banker can readily advance loans against the security of government securities.
5. Unlike other assets, securities are not idle assets. They earn interest or dividend periodically. The amount of income so received can be credited to the loan account

6. Advancing against stock exchange securities attracts four convenient points.

   One, the market value of securities can be known easily through media and the prices of securities can be known through stock exchanges. Two, title of the securities can be known easily writing to the issuing authority or body. Three, stock exchange securities can be transferred easily. Four, in case of default securities can be sold in the market and get back the amount due from the borrower.
7. After repayment by the borrower, the banker can release the securities without much expenses and formalities.

19.2.5.2 Risks involved in advancing against stock exchange securities:

1. When banker accepts partly paid securities as security and the borrower fails to pay the calls made by the company; with the fear of forfeiture, the banker bound to pay this calls arrears on behalf of the borrower.
2. Except bearer securities, all other securities are not negotiable instruments. Therefore, banker as a pledgee cannot get a better title than that of the pledger.
3. Wide fluctuations in case of certain shares and debentures are a threat to the banker. Therefore, banker has to maintain sufficient margins in case of such securities to avoid this kind of risk.
4. Some companies might have a right of lien for the calls or any other amount due by the shareholders. In case of such securities banker should be careful. He can avoid risk by not accepting such securities as security.
5. Banker should also be careful with regard to forged documents

19.2.5.3 Precautions to be taken while advancing against stock exchange securities:

1.Choice of Securities: Banker should be very careful while selecting the securities for advances. He should continuously in touch with the approved list of securities at the stock exchanges. Banker should also study the financial position of companies whose securities are going to be accepted for advancing.

2. Valuation of shares: While valuing the securities banker should be more careful. In no case he should take face value of the security. Market value is an appropriate one. Further, market values include dividend part. So securities are to be valued after deducting this part. Besides, banker should not only depend of stock exchange prices but also depend on the financial position and reputation of the company concerned.

3. Adequate margins: Because of chances for wide fluctuations in securities market banker should kept sufficient margins before advancing, otherwise banker faces problems.

4. Preferable securities: Banker should give preference-to-preference shares and debentures than of equity shares, as the risk in them is small. Similarly, he should give priority to the government securities.

5. Partly paid securities: Keeping the danger of forfeiture in mind banker should better avoid advancing loans to partly paid securities. If it is unavoidable, banker can take an undertaking from the customer that he would pay the call, if made by the company.

6. Transfer of securities: Banker obtains title of securities by mere delivery if they are bearer in nature. But if they are registered securities, they must be transferred in the name of the banker by registration only. Otherwise, in case of such securities mere delivery makes no use.

7. Intimation to the company: Banker after advancing loan to the borrower should inform the concerned company about the deed and thus avoid issuing of duplicate certificates to the borrower.

8. Own securities: According to Sec. 20 of the Banking Regulation Act, bank should not advance loans against its own securities.

19.2.6 Advances against real estates:

Real estate generally means an immovable property. However, real estate in today's practical sense means sites or plots, sites of house building societies, estates developed by private organizations etc. Banker lends advances against these securities in exceptional cases where the borrower has no other security to offer. In dealing with these real estates there are many difficulties that a banker can come across. Let us discuss about them in detail point wise.

19.2.6.1 Difficulties in dealing with real estates:

1. Title of the estate: It is difficult to identify the owner of a real estate. Many disputes and legal aspects are involved in many properties. Some properties may not have proper link documents. One site may be registered for more than one person. Some guilty persons may also produce wrong non-encumbrance certificates. Further, a person may get property by way of inheritance, gift, will, mortgage or sale, but the provisions relating to these are very complicated. Because of these, a banker may be in trouble to know whether the borrower has the valid title to the property or not.

2. Valuation: Valuation of real estate is another problem that a banker faces. For correct valuation purposes, banker has to take the services of experts in this field. Further, ups and downs in prices of real estate values also poses problem to the banker.

3. Expensive: To advance on real estate requires a legal mortgage. It is an Expensive affair. The borrower has to bear all these expenses, which in result costs him higher.

4. Maintenance: Advance against real estate is not an end. The banker has to look after the maintenance of the estate like finding suitable tenants, collecting rents, incurring expenditure on repairs, protection of the Property from anti -social elements etc. Further, if the borrower fails to pay the dues in time, the banker has to sell the mortgaged property, which takes time and creates inconvenience to the banker.

5. Poor liquidity: Generally, borrowers on real estate property need long term advances. But for commercial banks this hamper the liquidity position. In case of default, it is not easy to sell the mortgaged property in a short period finding suitable buyers. Further, selling formalities take time. Therefore, lending on real estates show direct impact on the liquidity position of the bank.

19.2.6.2 Precautions to be taken while advancing against real estates:

After knowing the above difficulties, banker has to take the following precautions while advancing against real estates.

1. Verification of titles: Before advancing loan against real estate, the banker should verify the title deeds of such property. Mere deeds or registration forms may not be sufficient. There may be many legal complications involved in them. Therefore, he should better take the advice of the solicitors and move accordingly.

2. Non-encumbrance certificate: There is a possibility of mortgage of a single property at more than one place. Banker should always try to get first mortgage on the property f or safer side. Therefore, he should get non-encumbrance certificate from the registrar's office and verify whether the property was previously mortgaged to any one or not.

3. Leased property: If the borrower brings leased property for security purpose, banker should examine the terms of the lease and unexpired portion of the lease deed. Further, the banker should ensure that the government for acquisition of susch property serves no notice.

4. Valuation: Banker, normally, is not an expert in valuing the real estates. Therefore, he should take the services of an expert for valuation purposes, which reduces the risk of the banker to a greater extent.

5. Adequate margin: Real estates prices of subject to market fluctuations. So the banker, on safe side, should maintain sufficient margin while granting advances. Normally, banker maintains around 50% as margin on the value of the estate.

6. Mortgage: Banker should go for legal mortgage for real estate property, which requires registration. In case of companies both legal and equitable mortgages are to be made compulsorily.

7. Insurance: The borrower must insure Building or a factory premises like real estates against fire and other calamities and the policy should be assigned in four of the bank.

19.2.7 Advances against book debts:

Banker, sometimes, gives loans to his customer on his book debts. It means, based on the customer's customers dues loans are sanctioned. Generally, these types of loans are sectioned only for creditworthy and solvent customers. For banker it becomes 'actionable claim'. According to Sec. 130 of Transfer of Property Act, 1882 actionable claims are allowed for assignment to other persons.

The customer may assign book debts as security deliberately because he is facing difficulty in recovering such debts. In case the customer fails to repay the loan, the banker has to perform the role of a debt collector and collect the money and credit to the customer's account. But no banker wants to be a debt collector. That is why the banker does not look advances against book debts with favour. Because of these factors, banker must be more cautious while advancing against book debts.

19.2.7.1 Precautions required in advancing against book debts:

1.The banker must insist for legal assignment of book debts in his favour by the customer. And this must be in writing, which is called assignment where banker is the assignee and customer an assignor.

2.The information about the assignment should be sent to all the debtors of the customer.

3.The banker should advance against book debts only to a creditworthy customer and take undertaking to pay all money received by him from his debtors in respect of assigned debts to the banker.

4.Sufficient margins should also be maintained while granting advances against these securities.

19.2.8 Advances against documents of title to goods:

According to Sec. 2(4) of the Sale of Goods Act 'documents of title to goods' include a bill of lading, dock warrant, warehouse-keeper's certificate, wharfinger's certificate, railway receipt, warrant or order for the delivery of goods and any other document used in the ordinary course of business as proof of the possession or control of goods, authorizing or purporting to authorize, either by endorsement or by delivery, the possession of the documents to transfer or receive goods thereby represented.

Thus, the document of title to goods can be said as a symbol of goods and is equivalent to the delivery of the goods. Therefore, banker used to advance against these documents frequently. Let us know briefly about important documents.

1. Bill of lading: A bill of lading is a document issued by the ship owner, or by the Master or other agent on his behalf, which states that certain goods have been shipped on a particular ship and sets out the terms on which such goods have been delivered to, and received by the ship.
2. Dock warrant: A dock warrant is a document issued by a dock company stating that the goods described therein are deliverable to the person named in the warrant, or to his assignee by the endorsement.
3. Warehouse-keeper's certificate: A warehouse-keeper's certificate is a deposit receipt of the goods that are with the warehouse.
4. Delivery order: A delivery order is an order addressed to the warehouse keeper where the goods are stored to deliver the goods mentioned therein to a particular person.
5. Railway receipt: A railway receipt is issued by the railways by which it acknowledges the receipt of goods described therein and undertakes to deliver the goods to the consignee at the place mentioned in it.

Advances against documents of title to goods are equivalent to pledge and in case of default by the borrower, the banker can take the possession of the goods. However, there are certain risks involved in advancing against documents of title to goods. Let us discuss about them.

19.2.8.1 Risks in documentary credit:

1. The documents of title to goods are not negotiable instruments. Therefore, the banker does not become the holder in due course. It is a risky business to the banker.
2. Sometimes the document of title to goods may be a forged one or the number of packages stated in it may be fraudulently altered. In case of railway receipts, the consignor may give the wrong description of goods because railway authorities do not guarantee the contents in the packages. If the banker advances loans against such receipts, he has to incur loss.

3. The borrower may take the delivery of goods without the notice of the banker on the basis of an indemnity bond. In such case, the banker suffers.

19.3 Summary:

There are various types of securities that a banker can advance against them. Goods, immovable property, stock exchange securities, real estates etc., are among them. For each type of security, banker should take proper care while advancing as many risks are involved in them. Advances against goods, immovable property and stock exchange securities are better securities than other securities.

19.4 Key words:

1. Goods: Every kind of movable property other than actionable claims and money.
2. Mortgage: Transfer of an interest in the specific immovable property for the purpose of securing advance.
3. Legal mortgage: Transfer of legal little in respect of the mortgaged property.

19.5 Self-Assessed Questions:

Very short questions:

1. What ate the advantages a banker gets if he advance loan against goods?
2. Distinguish between legal and equitable mortgage.
3. What are the precautions required in advancing against book debts?

Short questions:

1. What ate the precautions that a banker takes while advancing against goods?
2. Explain various types of mortgages.
3. Why banker does not show much interest in advancing against real estates?

Essay questions:

1. Discuss elaborately on advances against stock exchange securities.
2. Explain the pros and cons in advancing against documents of title to goods.

19.6 Suggested Readings:

1. Banking Theory and Practice — K.C.Shekhar and Lekshmy Shekhar
2. Banking Theory and Practice— P.K.Srivastava

Dr. R. Jaya Prakash Reddy

Lesson 20

Loans and Advances III

Types of Securities – Life policies and FDRs

20.0 Objectives:

The main purpose of this lesson is to help you to:

- Understand the merits and demerits of advances against life insurance policies and precautions to be taken by the banker in this regard.
- Study about advances against fixed deposit receipts and precautions that a banker should take while advancing.

Structure:

20.1 Introduction

20.2 Advances against life insurance policies

20.2.1 Advantages of life policies as security

20.2.2 Disadvantages of life policies as security

20.2.3 Precautions to be taken in advancing against life policies

20.3 Advances against fixed deposit receipts

20.3.1 Precautions in advancing against FDRs

20.4 Summary

20.5 Key words

20.6 Self-Assessment Questions

20.7 Suggested Readings

20.1 Introduction:

In the previous two lessons, we have discussed at length about loans and advances that a banker gives on various securities. In continuation to them, in this lesson, we discuss on two types of securities viz., life insurance policies and fixed deposit receipts (FDRs).

20.2 Advances against life Insurance policies:

A life insurance policy is a contract between the assured and the insurance company, in consideration of premium to be paid, undertakes to pay the specified amount of money after the expiry of a certain period or on the occurrence of the death of the assured. In India, up to recently, Life Insurance Corporation of India has the monopoly of life insurance business. But now the situation changed. Many companies entered this business. It is a usual practice, that insurance companies themselves grant loans on the policies of their customers. However, some customers approach banker for a loan offering his life policy as security.

Banker may accept life policies as main or supplementary security. He generally advances only 85 to 90% of a policy's surrender value. Further, the borrower will have to file a 'deed assignment' with the banker along with the actual policy and give an undertaking to the banker for the repayment of loan amount.

20.2.1 Advantages of life policies as security:

1. The value of the life policies can be ascertained easily. The surrender value of a policy can be calculated based on the policy bond or enquiring from the insurance company.
2. Banker can take the assignment of the policy with registration and this gives him no risk.
3. If the borrower continuously pays his premiums, the value of the policy increases continuously which strengthens the hands of the banker.
4. Even in case of insolvency of the borrower, the banker gets his amount through the assigned policy. If the borrower wants policy amount, he has to first clear of bank debt.
5. The bank can further assign the policy assigned in its favour to a third party as security for an advance.
6. The banker need not take much care of the security. In case of borrower's default banker can get the due amount from the insurance company.

20.2.2 Disadvantages of life policies as security:

1. Insurance is a contract reached between the assured and the insuring company in utmost good faith. While reaching such an agreement if the borrower could not reveal the material facts to the insurance company the agreement becomes null and void. In such cases banker as a lender may not get back money from the default borrower even though he has his life policy as security.
2. Normally, suicides are not covered in insurance policies. In case of borrower's suicide the policyholder i.e., the banker would not get the loan amount back.
3. The laws relating to assignment of life policies are not strong in India. Under certain circumstances the banker may not get the policy amount of the borrower even though he has his assigned life policy.
4. If the life insurance company does not admit the age of the assured, it will become difficult for the bank to prove the same in the event of his death.

20.2.3 Precautions to be taken in advancing against life policies:

1. Banker has to verify the interest of the insurance company on the insured person. After verifying the policy at length and after satisfaction only banker can lend loan to the person concerned. Life policies of his wife and children may also be considered for security.
2. Banker should verify whether the insurance company has admitted the age of the assured. Other wise, banker should not take up such cases.
3. Among various types of insurance policies, banker should prefer endowment policy. It is payable after the expiry of a fixed period or on the death of the party if it occurs earlier.

4. Before considering sectioning of advance on life policy, the banker should go through all the clauses of the insurance company particularly the suicide clause. If there are any objectionable clauses, the banker better avoid such cases.
5. Banker can ask for legal assignment of the policy and verify whether there was any previous assignment. Banker can get a letter from the borrower to that effect.
6. Banker should maintain sufficient margin on the surrender value of the policy. If the borrower fails to pay the premiums at a later date, the insurance company may pay the surrender value after stipulated period only as per the agreement reached. Therefore, banker should take this additional time also into consideration.

20.3 Advances against Fixed Deposit Receipts (FDRs):

Depositors with excess money may opt going for fixed deposits at their banks. As the name denotes fixed deposit is a deposit where the depositor deposits money at the bank for a fixed period. The banker issues fixed deposit receipt to that effect. He is entitled at a certain percent of interest for the specified period. However, he cannot withdraw the deposit before that time. If he wants so the banker may reduce the interest drastically as per the agreement and pays back to the depositor. This is not a favourable aspect to the depositor. Therefore, depositors sometimes approach the banker for loan keeping the FDRs as security. This is the way the depositor gets back money even before expiry of the fixed deposit period. Banker charges higher rate of interest on loan than on fixed deposits. However, for borrower, the purpose is served. Thus, for example, if a fixed deposit has been made for 60 months and the customer requires the money for a month or so, it is better to take loan against the fixed deposit receipt. However, in this respect the banker should take certain precautions while dealing with FDRs.

20.3.1 Precautions in advancing against FDRs:

1. It is better for a banker to advance loans on the FDRs of his own bank. Loans on FDRs of other banks may have some risks. The depositor might have taken loans already on these FDRs.
2. Banker should sanction loan to the person in whose name the FDRs are issued. In case the banker-sanctioning loan to the third party, he should get the authority from the owner of the receipt and get the receipt duly discharged.
3. The banker should take the possession of FDRs while sanctioning loans, as they are not negotiable or not transferable.
4. When the FDRs are in the names of more than one person and loan is going to be given to one of the depositors, the banker has to get the authority letters from the remaining persons. Further, they should also sign a memorandum of pledge.
5. To avoid legal complications, it is better to avoid loans to minor children.
6. In case of default, the banker after the maturity of the FDRs transfer the proceeds to the loan account and the remaining amount if any will be refunded to the depositor cum borrower.

20.4 Summary:

Banker can also lends advances on life insurance policies and FDRs. In advancing against life policies there are certain advantages and disadvantages. The banker should be cautious while lending against life policies. Of course, FDRs are safer security to the banker if they are of the same bank. However, banker should take certain precautions while lending against FDRs.

20.5 Key words:

1. Life Insurance Policy: It is a contract between the assured and the insurance company on the life of the assured.
2. FDRS: Receipts given by the banker for the deposits made by the depositor for a fixed period.

20.6 Self-Assessment Questions:

Very short questions:

1. What are the merits in advancing against life policies?
2. What are the demerits in advancing against life policies?

Short questions:

1. What are the merits and demerits in advancing against life policies?
2. Explain the precautions to be taken by the banker while advancing loans against FDRs.

Essay question:

1. What precautions should a banker take while advancing money on the security of a life policy? Discuss the advantages and disadvantages of such a security.

20.7 Suggested Readings:

1. Banking theory and practice —— K.C.Shekhar and Lekshmy shekhar
2. Banking theory and practice —— P.K.Srivastava

Dr. R. Jaya Prakash Reddy