BANKING:
COMMERCIAL BANKING
(DCM26)
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M.Com. FINAL YEAR SYLLABUS

PAPER - III : COMMERCIAL BANKING

Types of Banks : Money Market and Capital Market - Money - Market Institutions - Central Bank, Commercial Banks, Cooperative Banks, Regional Rural Banks, Indigenous Financial Agencies - Discounting Houses. Accepting Houses - Foreign Banks.

Capital Market Institutions : Investment Banks, Merchant Banks, Investment Companies, Development Banks, Stock Exchange, Mutual Funds, Depositing system in India.

Banking Systems : Group Banking and Chain Banking - Unit Banking - Correspondent Banking and Mixed Banking

Development of Commercial Banks in U.S.A. and India : Nationalisation of Commercial Banks in India - Performance evaluation of Commercial Banks - Branch expansion - Policy of the RBI - Problems in the branch expansion in rural areas - Resource mobilization - Trends and innovations - Problems in the Mobilisation of deposits - Marketing approach to banking - Depositors right - Deposit Insurance and Credit Guarantee Corporation (D.I.C.G.C.)

Investment Policies and Procedures of commercial banks - RBI guidelines - Capital adequacy norms and bank balance sheet - Recommendation of the Narasimham Committee.

Different types of Lending : Lending to industry and trade - Lending to corporate sector - working capital financing by commercial banks - The Dadeja study group and Tandon Committee recommendations - Cash credit System and Chore panel's recommendations - priority sector lending policies and practices of commercial banks - Schemes relating to agriculture - Small Scale Industry - Traders and small business entrepreneurs - Self employees and professionals - Transport operators - Education and other schemes.

Committee recommendations (1986) National Bank for Agricultural and Rural Development (NABARD) - Genesis and working - Financing of export and import trade by commercial banks - EXIM bank: Origin, development and working.

Profitability and profitability planning in commercial banks. Measures to improve Profitability of the banks - HRM in commercial banks - Recruitment, training - Welfare measures and industrial relations in commercial banks - Funds and malpractices in banks, Ghosh Committee recommendations.

Customer Service in commercial banks - Goiporia Committee recommendations - Social responsibilities of commercial banks - Innovations in banking services - Credit cards - Merchant banking - Mutual funds - Management information system for banks (performance budgeting in commercial banks - Concept and applicability of Computerisation in commercial banks - Rangarajan Committee recommendations - Diversification of banking business in India - Scope for research in banking industry).

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LESSON - 1

MONEY MARKET : STRUCTURE AND INSTITUTIONS

OBJECTIVE :

This lesson aims at equipping the students with complete information about different Instruments in the Money Market. The important features of the Money Market are discussed at length to give the students a fair degree of understanding about the concepts of Money Market.

STRUCTURE :

1.1 Meaning
1.2 Structure of Money Market
1.3 Functions
1.4 Objectives of Money Market
1.5 Money Market Instruments
1.6 Treasury Bills
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1.43 Supervisory and Regulatory Framework
1.44 Recent Development
1.45 Introduction
1.46 Function and working of Discount Finance Corporation
1.47 Discounting Service

1.1 MEANING :

Financial Markets are basically classified into (a) Money Market and (b) Capital Market. This classification is on the basis of term 'credit' i.e., whether the credit is supplied for a short period or long period. Money Market refers to Institutional arrangements which deal with short term funds. In other words, the Money Market is a large whole sale Market wherein crores of Rupees of low risk, un-secured, short-term, zero coupon debt. Instruments that are highly liquid are issued and actively traded everyday. According to Growther, "The Money Market is a collective name given to the various Firms and Institutions that deal with various grades of Near money. J.S.G. Wilson defined the Money Market as a "centre in which Financial Institutions congregate for the purpose of dealing impersonality in monetary assets". The Reserve Bank of India defines Money Market "as the centre for dealing mainly of a short-term character in monetary assets, it meets the short-term requirements of borrowers and provides liquidity or cash to the lenders". Money Market has no geographical constraints and relates to all dealings in Money or Monetary Assets. To be short, Money Market can be explained as a centre where borrowers and lenders of money and near money assets are put together. The Money Market consists of a group of such markets for various varieties of money assets characterised by relative liquidity or nearness to money. The term Money Market encompasses a variety of transactions, instruments and institutions. Call Money Market and Bill Market are its components. Treasury Bills, Commercial Paper, Certificate of Deposits are some of the instruments of Money Market.

1.2 STRUCTURE OF INDIAN MONEY MARKET :

(i) Broadly speaking the Money Market in India comprises of two sectors (a) Organised sector and (b) Unorganised sector.

(ii) The organised sector consists of the Reserve Bank of India, the State Bank of India with its associates, Nationalised Commercial Banks, other scheduled and non-scheduled Commercial Banks, Foreign Banks and Regional Rural Banks. It is called organised because its part are systematically co-ordinated by the Reserve Bank of India.

(iii) Non-Bank Financial Institutions such as LIC, the GIC and subsidiaries, the UTI also operate in this market, but only indirectly through banks and not directly.

(iv) Quasi-Government Bodies and large companies also make their short term surplus funds available to the organised market through banks.

(v) Co-operative Credit Institutions occupy the intermediary position between organised and unorganised parts of the Indian Money Market. These Institutions have a three-tier structure. At the top, there are State Co-operative Banks. At the local level there are primary credit societies and Urban Co-operative Banks. Considering the size, methods of operations and dealings with the RBI and Commercial Banks, only State and Central Co-operative Banks should be included in the organised sector. The co-operative societies at the local level are only loosely linked with it.

(vi) The un-organised sector consists of Indigenous banks and money lenders. It is un-organised because activities of its parts are not systematically co-ordinated by the RBI.

(vii) The money lenders operate throughout the country, but without any link among themselves.

(viii) Indigenous Banks are somewhat better organised because they enjoy re-discount facilities from the Commercial banks, which inturn have link with the RBI. But this type of organisation represents only a loose like with the RBI.

1.3 FUNCTIONS :

A money market functions primarily as an aid to Banks and Financial Institutions as a result, they may use their surplus funds. The short-term Government securities market is also said to be a constituent part of the Money Market. The Money Market also cover a group of markets for various types of money assets characterised by relative liquidity or proximity to money. Such assets may be call money. Treasury Bills or Bills of Exchange, etc...

The Investors purchase Money Market securities at discount from their face values and reap whatever income they may generate from price appreciation that happens as the due date of the security draws near. On the date of maturity the face value is re-paid to the Investor owning the security on that date. If market interest rates increases, then the market prices of almost all debt securities fall in response, so investor looses consequent to the changes in the market interest rates. This is known as interest rate risk.

Though there are different centres of Money Market such as Mumbai, Kolkatta, Chennai etc., they are not separate independent markets but are interlinked and related. The Financial Institutions dealing in these assets may be spread over so wide a geographical area that it would be impossible to specify the geographical limits of the market.

1.4 OBJECTIVES OF MONEY MARKET :

As mentioned Supra, the main objective of money market operations is conversion of cash into short-term instruments of money market using the surplus cash for earning good return and convert bank into cash form to meet liquidity obligations. The dual objective of investment is to maintain equilibrium between the opposing motives of liquidity obligations and income earnings. Expertise and experience are needed in choosing appropriate investments among Treasury Bills, Commercial Bills, Inter-corporate Investments and Commercial Paper, etc... which facilitates

optimization of returns without sacrificing the liquidity needs. A sound knowledge of money markets helps an investor in deciding as to which instrument to be purchased, how much to invest in each if the instruments, amounts of risk the investor can take for a desired rate of return.

1.5 MONEY MARKET INSTRUMENTS :

Various types of instruments are issued and traded in Money Market in India. Some of them are Treasury Bills, Commercial Bills, Certificate of Deposit, Commercial Paper, Call Money which are discussed briefly below.

1.6 TREASURY BILLS :

A Treasury Bill is a kind of Finance bill or Promissory note issued by the government of the country to raise short-term funds. Although State Governments also issued Treasury Bills on occassions until 1950, since then it is only the Central Government has been selling them. Treasury Bills are not self-liquidating in the way genuine Trade Bills, although the degree of their liquidity is greater than that of Trade Bills. If one were to arrange short-term financial instruments according to their liquidity, the descending order would be cash, call loans, Treasury bills and Commercial bills. Treasury bills are highly liquid because there cannot be a better guarantee of repayment than the one given by the Government and because the Central Bank of the country is always willing to purchase or discount them. Two types of Treasury Bills have been in vogue in India (1) ordinary (2) Adhoc. The former are issued to the public and the RBI for enabling the government to meet the needs of supplementary short-term finance. The practice of issuing adhoc TB's also known as adhocs in short, has been discontinued recently through the signing of two agreements between the Government and the RBI.

The instrument of adhoc treasury bill and the system of issuing it were introduced in India in 1937. As per the agreements made between the GOI and RBI in 1937 and 1955, it was decided that the Government shall maintain with the RBI a cash balance of not less than Rs. 50 crore on Fridays and Rs. 4 crore on other days free of obligation to pay interest thereon, and whenever the balance falls below these minimums the Government account would be replenished by the creation of adhocs in favour of the RBI. The system of Adhoc TBs financing became permanent in subsequent years of the planning era.

Treasury Bills are issued at a discount by the RBI on behalf of the Central Government as its agent. They are issued by Tender or on tap. India has experimented with 91 day TBs, 182 day TBs, 364 day TBs and two types of 14 day TBs. The Adhoc 91 day TB has been discontinued with effect from 1 April 1997. The 182 day TB was launched in November 1986 and discontinued from 1 April 1982. The 364 day TB was introduced on 1 April 1992. Two types of 14 day TBs have been introduced very recently. One with effect from 1 April 1997 and the second w.e. from 20th May 1997. The former is known as the intermediate Treasury Bill and it has replaced the 91 day tap Treasury Bill. At present all types of TBs are sold through auctions. In the case of 91 day Tbs, the auction system was introduced from 1 January 1993 while in the case of other types of Bills, it was introduced from their respective dates of launching. In the case of 91 day TBs, the auctions are weekly and the amount for auction has to be notified, whereas in the case of other types of TBs, actions are fortnightly and there is no need to notify the auction amount. With the introduction of the auction system , interest rates on all types of TBs are being determined by the market forces. The important features of TBs are high

liquidity, absence of risk of default, ready availability, assured yield, low transaction cost, eligibility for inclusion in the S.L.R. and negligible capital depreciation. The total yearly sales and outstanding amount at the end of each year of 91 day Bills have increased enormously overtime. The 91 day Treasury Bills are purchased by the RBI, Commercial Banks, State Governments and other approved bodies and Financial Institutions like the LIC and UTI. The RBI and Banks together account for about 90 percent of the sales of this bill every year. The shares of the RBI and Banks in these sales have fluctuated over the years, they appears to be inversely related.

The other Treasury Bills are purchased by Foreign Banks in India, Indian Scheduled Banks, National Co-operative Development Organization, Provident Funds and the RBI cannot purchase these Bills. The Treasury Bills Market in India is narrow and under-developed. The narrow market in the 91 day Treasury Bills is due to the fact that they can be easily re-discounted with the RBI, they offer a very low rate of return and banks prefer to invest in Government Securities to earn higher income. The narrow market in other types of Bill may be due to their newness.

The Treasury Bill being a highly liquid money market instrument, its sales to Banks in large amounts creates a threat to the working of monetary policy. The Central Banks follows a policy of funding these Bills to minimise this problem. After de-regulation, the yields on TBs have been quite attractive. The yield on 364 day TBs has been slightly higher than the yield on 91 days TBs. The sizes of the auction markets in 91 day and 364 day TBs have been comparable in certain years. Hence, TBs occupy a significant position in the Money Market.

1.7 TYPES OF TREASURY BILLS :

The Treasury Bills which are in vogue in India are basically of two types. (1) Ordinary and (2) Adhoc. The ordinary Bills are issued to the public by the Reserve Bank of India to enable the Central Government to meet its needs for supplementary short-tern finance.

The Adhoc Bills are created in favour of the Reserve Bank of India to achieve twin objectives.

(i) First, they replenish Government's cash balances. The finance raised by the Central Government through these bills can be regarded as a counter part of "ways and means" advances made by the Reserve Bank of India to the State Governments.

ii) Secondly, they provide the medium for the employment of temporary surpluses of State Government and Semi-Government departments and Prevent undesirable fluctuations in the discount rates which would result if State Government were to compete with regular investors in the Treasury Bills issued to the Public.

1.8 COMMERCIAL BILLS :

1. Funds for working capital required by commerce and industry are mainly provided by banks through cash credits, overdrafts and purchase/ discounting of Commercial Bills. A Commercial Bill or Bill of Exchange is a short term, negotiable and self-liquidating money market instrument which evidences the liability to make a payment on a fixed date when goods are bought on credit. It is an asset with a degree of liquidity and low degree of Risk.
2. There are two types of Bills. One is Demand Bill and another one is Usance Bill. A Demand Bill is payable "at sight" or on "Presentment" to the drawce. Usance or time bill is payable at a specified late date.

3. Commercial Bills can also be classified as Clear Bills. Documentary Bills, Inland Bills, Foreign accommodation Bills and Supply Bills.
4. Commercial Bills are used to Finance the movement and storage of Agricultural and Industrial goods in domestic and foreign trade.
5. The indigenous variety of Bill of Exchange is called 'Hundi'. It has a long tradition of use by the indigenous Bankers for financing the movement of Agricultural Produce.
6. The financial service of acceptance is important for increasing the liquidity of Commercial Bills. It refers to the sale (for a fee) of the use of a name as an effective guarantor that there will be no default on the Bill of Exchange.
7. The normal maturity period of Bills varies considerably as follows. (a) Usance Hundi 30 to 120 days (b) Export Bills 90 days (c) Import Bills 60 days (d) Internal Trade Bills 90 to 180 days.
8. The Bill market in India is under developed. There is little market for Bills of Exchange in the real sense of the term except the one created by the RBI for the purpose of accommedation. There is no continuous and substantial supply of bills. The well established and widespread practice of borrowing against bills is absent and Commercial Banks do not make much use of the Bill of Exchange while providing credit.
9. The share of Bill Finance in the total bank credit is quite small. It has varied between 8 to 22 percent during 1950-51 to 1995-96.
10. At present the Reserve Bank of India has introduced two Bill market schemes, one is 1952 and the other in 1970 to develop the Bill market. With effect from May 1990, more than 25 (types of) Institutions have been permitted to rediscount Commercial Bills under the latter scheme.
11. The rates which reflect the cost of Bill Finance are Bank rate, SBI Hundi rate, Bazaar Bill rate, SBI Discount rate and Commercial Banks Bill Finance rate. Most of these rates have ceased to be operative one after another.
12. The RBI used to prescribe a ceiling on the rate of discount at which a bill could be discounted by banks with other Commercial Banks and with approved Institutions. With effect from May 1989, this ceiling has been withdrawn by the Bank.
13. There is a limited market in India for long term bills also. This market has come into being with the introduction of the Bills rediscounting scheme by the IDBI, SIDBI etc. for the purpose of re-discounting bills arising out of the sale of machinery on differed payment basis.
14. Important changes have taken place in the structure of Bill Finance in the recent past. From around 1991-92, the supply of foreign bills has exceeded that of inland Bills and the amount of bills discounted has exceeded that of bills purchased in respect of inland bills; but in respect of foreign bills, bills purchased continue to be higher than bills discounted.
15. The volume of bills rediscounted by the RBI, IDBI and other all India FI's had declined over the years, indicating that the availability of rediscounting facility has declined with passage of time Main reasons that can be attributed to the poor development of Bill market in India are :-
    i) Lack of uniformity in drawing bills.
    ii) Varying borrowing practices in different parts of the country with respect to bills.

iii) Absence of distinction between Trade Bill and Finance Bill.
iv) High stamp duty.
v) Popularity of cash credit and overdraft arrangements as a means of borrowing from Commercial Banks.
vi) Traditional attachment to cash transaction and neglect of credit transactions etc.

1.9 CERTIFICATE OF DEPOSIT :

Certificate of Deposits are bank deposit accounts which are transferable from one party to another. They are marketable or negotiable short term instruments in bearer form and are known as Negotiable Certificates of Deposit (NCD) also. They are marketable receipts in bearer or registered form of funds deposited in a Bank for a specified period at a specified rate of interest i.e. they are documents of title to Time Deposits with Banks Certificate of Deposits (CDs) are interest bearing, maturity dated obligations of banks and technically they are a part of Bank's Time Deposits. They are negotiable because they are payable either to the bearer or to the order of the depositor. They can be sold to someone else and are traded on the secondary markets. Liquidity and marketability are said to be the Halt marks of Certificate of Deposits. Certificate of Deposits are also virtually riskless in terms of default of payment of interest and principal.

CDs are the obligations of banks just as finance papers are the obligations of Finance companies CDs are usually issued at face value, on which fixed rates of interest are paid and they are traded on a bond yield equivalent basis, but the issues of CDs on a discount face value basis are also known to the market if they are issued on discount basis they are similar to Treasury BIlls or Commercial Bills. But if they are not so issued, they differ from these other money market instruments. CD's are also like Bonds. Unlike TBs, CDs lack homogeneity in respect of the issues, maturity interest rate and other features, therefore, trading in CDs normally can never become as important as trading in TB's.

Certificate of Deposit is a document of title to a time deposit. It is a bearer certificate and is negotiable in the market. Only banks can issue CD's. The minimum CD used to be for Rs. 1 crore. Later lowered to Rs. 50 lakhs and in multiples of Rs. 25 lakhs and then further lowered to Rs. 10 lakhs.

CHARACTERISTICS :

1. Certificate of Deposit is issued by banks against deposits kept by individuals companies and institutions.
2. It is marketable after 45 days.
3. It can have tenure of 91 days to 1 year.
4. It is issued on discounting basis.
5. No loans and Buy backs are permitted.
6. No duplicates are to be issued by Banks.
7. Banks cannot discount them or negotiate them.
8. There is no ceiling interest rate on them.
9. The RBI may fix an aggregate limit of maturity period for them.
10. The CDs are permitted upto 1% of average aggregate deposits. Later raised to 10% of average aggregate deposits of Banks.

11. The years of introduction of CDs in a few other countries were as follows : Japan -1979, France -1985, West Germany -1986, Australia -1969, New Zealand -1971, South Korea - 1974, Malaysia -1979, Indonesia -1971. The major motive for introducing CDs by Banks appears to have been to meet competition and maintain the share of Financial Markets by means of this instrument which has some advantages over the time deposit which is the other major means of mobilizing resources by Banks.

Since the beginning of the 1980s, the possibility of introducing CD's in India was being seriously assessed. The TAMBE working Group studied in 1982 its feasibility and recommended against it for the following reasons (a) There were no secondary money markets (b) There was the Administrated system of Interest rates and (c) There was the possibility that CDs might give rise to fictitious transactions. The Vaghul Working Group studied the matter again five years later (1987) and was in favour of introducing CDs, provided short term deposit rates were aligned with other interest rates in the system. Ultimately, following the rationalisation of interest rates on short term deposits. The RBI formulated and launched in June 1989, a scheme permitting banks to issue CDs "with a view to further widen the range of money market instruments and to give investors greater flexibility in the deployment of their short term surplus funds".

1.10 COMMERCIAL PAPERS :

What is called Commercial paper is quite a new instruments in the Money market. This is so even in the advanced countries except in the U.S. where it has been in vogue since the early 19th century. However, in all other countries it is only a post 1980 phenomenon. The years in which commercial papers came to be introduced in some foreign countries are U.K - 1986, France - 1985, Japan - 1987, Canada - 1950's, Sweeden early 1980s, Spain - 1982, Norway - 1984, Netherlands - 1986, Hongkong -1982 and Singapore - 1984.

Commercial papers are short term Usance Promissory Notes with fixed maturity issued mostly by the leading, nationally reputed, credit worthy, and highly rated large corporations. The other, although less well known names of CPs are Industrial Paper, Finance Paper and Corporate Paper - the names depend upon whose liability the paper is. If it is a liability of the Business or Industrial or Commercial or manufacturing concern, it is known as Industrial or Commercial Paper. If it is the liability of the Financial Company, it can be called a Finance Paper. Corporate paper is a wide term indicating that it is issued by corporations which may be either financial or non-financial. Commercial papers are issued in Domestic as well as International Financial Markets. In the case of later, they are known as Euro Commercial Papers.

Strictly speaking CPs are un-secured they are backed only backed by the general credit standing of the issuing companies and by the lines of credit that they might be in a position to obtain from Banks. They are negotiable by endorsement and delivery. They are regarded as highly safe and liquid Instruments. They are believed to be one of the highest quality investment instruments available from the private sector. They are also known to be a simple and flexible instruments in respect of documentation needed and the spread of maturities available.

As a matter of fact, these are un-secured promissory notes issued by the companies with a net worth equivalent to Rs. 4 crores. Its maximum Permissible Bank Finance (MPBP) for working capital requirements should not be less than Rs. 25 crores (Later reduced to Rs. 4 crores). The

company should have a credit rating of P. from the CRISIL and a Status Health Code No 1 from Bankers. The company should have current ratio of 1.33 : 1 and should have been listed on a stock exchange.

1.11 FEATURES :

1) The Tenor of these instruments should be 3 to 6 months issued with a minimum size of Rs. 25 lakhs in denominations of Rs. 5 lakhs each.
2) The ceiling amount of such issue is now 100% of the cash credit limit with banks.
3) The trading unit should be of Rs. 5 lakhs.
4) The issue should be in the form of Promissory notes.
5) Such promissory notes should not be under-written but should be privately placed.
6) In this process brokers have a role for placement and sale of this issue.
7) The initial Investor would pay the discounted value of the CP with a given tenor of 3 to 12 months and this determines the discount rate.
8) The Investor could be an individual, a bank, a company or an un incorporated body.
9) The stamp duty and other charges like issue expenses, commitment charges, credit rating charges etc., are all payable by the company.
10) The Interest rate on these instruments is determined by its discounted value. Thus if the paper of 6 months Tenor for Rs. 100 is discounted for Rs. 92 this gives an interest rate of 16% per annum.

$$\frac{100 - 92 \text{ x } 12}{6} = 16$$

Since commercial paper is an un-secured investment its interest rate would be higher than that on the Inter bank rate or the bill discounting rate. This rate should be compared with the rate on Inter Corporate Investments.

As the brokers are already operating in the inter corporate market as also in company deposits it is expected that they also play a role in the marketing of commercial paper. A time may come when the secondary market can also be developed in them. Although these instruments fall more aptly in the short term money market, the brokers are eligible and are operating in this market as much as in the new issue market or the long term capital market.

1.12 CHARACTERISTICS :

1) A company which is listed on one or more of the Stock exchanges only can issue commercial paper. The company can be a FERA company or an Indian company.
2) The maturity period should be 3-6 months and the issue should be for a minimum of Rs. 1 crore (later reduced to Rs. 25 lakhs) and in multiples of Rs. 25 lakhs (later reduced to 5 lakhs).
3) The companies with good credit rating are allowed to borrow through issue of commercial paper of 91 days to 182 days with market determined rate of interest.
4) It is an Un-secured promissory note for a stipulated amount that matures on a specific date and is issued by a corporation.

5) Though commercial paper can be issued in bearer form and as a registered security the bearer form is more popular.
6) Most of them are held till maturity but if there are any investors who would like to liquidate their commercial paper before its maturity date, they can do so in the secondary markets.

1.13 FACTORING SERVICES :

Bills involving, the bills receivable and bills payable to companies and Banks and converted into Factorisation bills with or without Recourse (with a protection against Bad Debts). These factoring and allied services are being provided by subsidiaries set up by Banks namely, SBI, Canara Bank, PWB etc., These Bills are purchased by the subsidiaries mentioned above from the creditors and the funds are collected in due course from the debtors. These Bills can be either with risk or without risk involved in all debt collection. It would be repaid out Bank Credit Limit. This link was cut off in October 1994 with the result that the CP stands on credit worthiness of the company.

The Secondary market transactions may be for an amount of Rs. 5 lakhs and multiplies. The RBI's prior permission is required for each issue and the general permission is required for each company to enter this market which was later delegated to the banks. The CP should be raised only for working capital purposes and should be less than 75% of the cash credit limit of bank's finance to the company. This was made 100% in cases the bank finance limits are more than Rs. 20 crores.

In 1996, it was completely delinked from cash credit limits of Banks. The Banks are authorised to decide on the terms and amount of the CP, issued by the company. The company will have to bear the expenses of the issue, commitment charges, stamp duty etc., These are not permitted to be under written. The NRIS are permitted to invest on a non-repatriation Basis. A company may enter into stand by facilities with bankers to ensure the meeting of the CP liabilities of the company. The brokers can enter only in the secondary market trading as the issue is not permitted to be underwritten.

BENIFITS OF FACTORING :

1) Normally margin on book debts is high under Factoring such margins could get reduced and availability of funds will increase.
2) Beneficial to client operating in buyer's market.
3) Advantageous to SSI and medium scale units delayed payments by large scale industries can be get over and cash flow will improve.
4) Clients concentrate on production and selling activities.
5) Time and cost of collection of debts are reduced.

1.14 CALL MONEY :

Short term finance is called "Call Money". The day to day surplus funds of the Banks and other institutions are treated in the call money market. Though in U.S.A. and U.K. the Call Money Market has developed well, in India it has not yet developed well and a separate short term Call Money Market as such does not exist in India.

CHARACTERISTICS :

1) The call money is leant for a very short-time i.e., the Maturity of such call money loans varies between oneday to a fortnight.

2) The call money loans in India are normally given for the purpose of dealing in the Bullion Markets and Stock Exchanges.
3) This saves interest on cash credits and overdrafts.
4) Some Individuals of very high Financial status in Metropolitan cities like Mumbai use call money loans for ordinary trade.
5) The call money loans are also given to the bill market and for deals between the Banks. At one time, only a few large Banks, particularly, Foreign Banks operated in the call money market. At present, even the small banks and non-scheduled banks participate in the call money market. The SBI which was inactive till 1970, is presently participating in a big way regularly and actively in the call money market.

CENTRAL BANK

Objective :

After going through this lesson students are able to understand about the Cental Bank, its Functions, Management, Role and Relevance in the Economy.

STRUCTURE :

1.15 Introduction
1.16 Management
1.17 Organisation
1.18 Functions
1.19 Monetary Policy Of the Reserve Bank of India
1.20 Review of Working of Monetary System Chakravarthy Committee Report
1.21 Central Bank and Rural Finance
1.22 Central Bank and Industrial Finance

1.15 INTRODUCTION :

The Reserve Bank of India is India's Central Bank. It is the apex Monetary Institution which supervises, regulates, controls and develops the Monetary and Financial System of country. The Reserve Bank was established on April 1, 1935. Under the Reserve Bank of India Act 1934. At the outset it was constituted as a Private Shareholders Bank with fully paid up capital of Rs. 5 crore. But this was nationalised on January 1, 1949.

1.16 MANAGEMENT :

The Management of the Reserve Bank is under the control of Cental Board of Directors consisting of 20 members (a) The Executive Head of the Bank is called Governor (at present Y.V. Reddy) who is assisted by Four Deputy Governors at present (Vepa Kamesam) (2) Sri. Rakesh Mohan (3) Sri. K.J. Udeshi (4) Vaucant - These Deputy Governors are appointed by the Government of India for a period of 5 years. The Head Officer of the Reserve Bank is at Mumbai. There are four Local Boards at (1) Delhi (2) Kolkata (3) Chennai and (4) Mumbai representing Four Regional Areas i.e., Northern, Eastern, Southern and Western respectively. These Local Boards are advisory in nature and the Government of India nominates one member each from these Boards to the Central Board. (c) There are ten Directors from various fields and one Government Official from the Ministry

of Finance. These directors will be Nominated under section 8(1) (c) of the RBI Act 1934 and at present the following Directors have been Nominated (1) Sri Ratan N - Tata (2) Smt. Amrita Patel (3) Sri. K.P. Singh (4) Sri V.S. Vyas (5) Sri D.S. Brar (6) Sri C.N.R. Rao (7) Sri H.P. Ranina (8) Sri N.R. Narayana Murthy (9) Sri Suresh Krishna (10) Sri Ashok S. Ganguly.

The Reserve Bank of India Act 1934 requires that there must be atleast six meetings in a year and the gap between two meetings must not exceed three months. The Governor of Reserve Bank of India can call a meeting of the Central Board whenever he feels it necessary. The Governor and the Deputy Governors are full time officials of the R.B.I and are paid prescribed salaries and allowances. Other Directors are part-time officials and are given fare and allowances to participate in the meetings.

1.17 ORGANISATION :

From the organization point of views the Reserve Bank of India operates through various Departments. They are :

1) Issue Department : Its main function is to issue and Distribute the Paper Currency.

2) Banking Department : This Department (a) deals with the Government Transactions, manage public debt and arrange for the transfer of Government funds. (b) maintains the cash reserves of the Scheduled Banks, provides Financial accommodation to the Banks and Function as a clearing House.

3) Department of Banking Operations : Its function is to supervise, regulate and control the working of the Banking Institutions in the country. It grants licences for opening new Banks or the new branches of the Existing Banks.

4) Department of Banking Development : It aims at expanding Banking facilities in Un Banked and Rural areas.

5) Agricultural Credit Department : It deals with the problems of agriculture credit and provides facilities of Rural Credit to State Governments and State Co-operatives.

6) Industrial Finance Department : Its main objective is to provide Financial help to the small and medium scale Industries.

7) Non-Banking Companies Department : This supervises the activities of Non-Banking Companies and Financial Institutions in the country.

8) Exchange Control Department : It conducts the business of sale and purchase of Foreign Exchange.

9) Legal Department : It provides advice to various Departments on Legal Issues. It also gives Legal advice on the implementation of Banking Laws in the country.

10) Department of Research and Statistics : The objective of this Department (a) to conduct Research on problems relating to Money, Credit, Finance Production etc., (b) to collect important statistics relating to various aspects of the Economy and (c) publish these statistics.

11) Department of Planning And Reorganization : It deals with the formulation of new plans or reorganization of existing policies for making them more effective.

12) Economic Department : It is concerned with the Formulation of New Banking Policies for better implementation of Economic Policies of the Government.

13) Inspection Department : It undertakes the function of inspecting various offices of the Commercial Banks.

14) Department of Accounts and Expenditure : It keeps proper records of all receipts and expenditure of the Reserve Bank.

15) RBI Services Board : It deals with the selection of new Employees for different posts in the Reserve Bank.

16) Department of Supervision : A new department i.e., Department of Supervision was set up on Dec. 22, 1993 for the Supervision Commercial Banks.

1.18 FUNCTIONS :

The Reserve Bank of India functions within the frame work of a mixed Economic System. With regard to framing various policies. It is necessary to maintain close and continuous collaboration between the Government and the Reserve Bank of India. In the event of a difference of opinion or conflict, the Government view or position can always be expected to prevail.

The Preamble of Reserve Bank of India Act 1934, States that "Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of Bank Notes and keeping of Reserves with a view to Securing Monetary Stability in (India) and generally to operate the Currency and Credit System of the Country to its advantage. The main functions of the RBI are :

1) To maintain monetary stability so that the Business and Economic life can deliver welfare gains of a properly functioning mixed Economy.
2) To maintain Financial Stability and ensure sound Financial Institutions so that monetary stability can be safely pursued and Economic Units can conduct their business with confidence.
3) To maintain stable payments system so that financial transactions can be safely and efficiently executed.
4) To Promote the development of Financial Infrastructure of Markets and Systems and to enable it to operate efficiently i.e., to play a loading role in developing a Sound Financial System so that it can discharge its regulatory function efficiently.
5) To ensure that credit allocation by the Financial system broadly reflects the National Economic Priorities and Societal concerns.
6) To regulate the overall volume of money and credit in the Economy with a view to ensure a reasonable degree of price stability. Apart from the above functions the following duties can also be performed by the RBI.

1) NOTE ISSUING AUTHORITY :

The RBI has since its inception, the sole right or authority or Monopoly of issuing Currency Notes other than one rupee notes and coins and coins of smaller denominations. The issue of Currency Notes is one of the basic functions of the RBI. The Bank can issue notes in the following denominations Rs. 2, 5, 10, 20, 50, 100, 500 and 1000. The responsibility of the Bank is not only to put Currency into or withdraw it from circulation but also to exchange notes and coins of one denomination into those of other denomination as demanded by the public. The Bank can issue Notes against the Security of Gold Coins and Gold Bullion, Foreign Securities, Rupee Coins, Government of India Securities and such Bills of Exchange and Promissory Notes as are eligible for purchase by the Bank.

2) GOVERNMENT BANKER :

The RBI is the Banker for the Central and State Governments. It provides to the Government all Banking Services such as acceptance of Deposits, withdrawal of funds by cheques, making payments as well as receipts and collection of payments on behalf of the Government, Transfer of funds and Management of Public debt.

The Bank receives Government Deposits free of Interest and it is not entitled to any remuneration for the conduct of the ordinary Banking Business of the Government. The Deficit or surplus in the Central Government Account with the RBI is managed by the creation and cancellation of Treasury Bills. As a Banker to the Government, the Bank can make “ways and means advances” (i.e., temporary advances made in order to bridge the temporary gap between receipts and payments) to both the Central and State Governments. The maximum maturity period of these advances is three months.

Apart from the ways and means advances the State Governments have made heavy use of overdrafts from the RBI. An overdraft refers to drawls of credit by the State Governments from the RBI in excess of the credit limits granted by the RBI. In otherwords, overdrafts are unauthorised ways and means advances drawn by the State Governments on the RBI.

3) BANKERS BANK :

The RBI like all Central Banks can be called a Bankers Bank because it has a very special relationship with Commercial and Co-operative Banks and the major part of its business is with these Banks. The Bank Controls the volume of reserves of Commercial Banks and thereby determines the Deposits/Credit creating ability of the Banks. The Banks hold a part or all of their reserves with the RBI. Similarly in times of need the Banks borrow funds from the RBI. It is therefore called the Bank of Last Report or the Lender of the Last Report. On the whole, the RBI is the ultimate source of Money and Credit in India.

4) SUPERVISING AUTHORITY :

The RBI has vast powers to Supervise and Control Commercial and Co-operative Banks with a view to developing an adequate and Sound Banking System in the country. It has, in this field the following powers (a) to issue licences for the establishment of New Banks (b) to issue licences for the setting up of Bank branches (c) to prescribe minimum requirements regarding paid up capital and reserves transfer to Reserve Fund and maintenance of Cash reserves and other liquid Assets. (d) To inspect the working of Banks in India as well as abroad in respect of their organizational set up, Branch Expansion, mobilization of Deposits, Investments and Credit Portfolio management, credit appraisal, Regionwise performance, Profit planning, Man power planning and Training etc., (e) to conduct adhoc investigations from time to time into complaints, irregularities and frauds in respect of Banks (f) To control methods of operations of Banks so that they do not Fritter away funds in improper Investments and in judicious advances (g) To control appointment, re-appointment, Termination of appointment of the Chairman and Chief Executive Officers of Private Sector Banks and (h) To approve or Force amalgamations.

In keeping with the Recommendations of Narasimham Committee (1991) the RBI function of Bank supervision was seperated from its Traditional Central Banking function by creation of Seperate Department of Supervision (DOS) from November 1993. Similarly, following the securities scam which showed the glaring weakness in the system for monitoring the Financial Sector, the Board of Financial Supervision (BFS) was set up on 16, November 1994 under the aegis of the RBI to oversee the IFS. The DOS initially took over the Inspection of Commercial Banks from the Department of Banking operations and Development (DBOD) of the RBI. Since April 1995, it has been taking steps to extend its area of supervision over the all India Financial Institutions also. In July 1995, it took over the supervision of Non-Banking Financial Companies (NBFCs) and in November 1995 the Registration

of these companies from the Department of Financial Companies (DFCs). The Board has a full time Vice-Chairman and six other members. The RBI Governor is its Chairman. It has powers to supervise and inspect Banks, Financial Institutions and NBFCs. There is a Five member Advisory Council to render advice to it. Observes feel that these Bodies have failed to curb both the raising number of frauds as well as bring down irregularities and their functioning is characterised by too much secrecy. It has been found that quite often, the DOS does not take action on Inspection Reports, that Banks continue to repeat their mistakes and that they continue to lend to defaulting parties even when they are blacklisted.

5) EXCHANGE CONTROL AUTHORITY :

Exchange Control was introduced in India on September 3, 1939 on the outbreak of the Second World War, by virtue of the Emergency Powers derived under the Financial Provisions of the Defence of India Rules, mainly to conserve the Non-sterling area currencies and utilise them for essential purposes. It was therefore decided to place the control on statutory basis and the Foreign Exchange Regulation Act 1947 was enacted. The Act which came into force on March 25, 1947 was valid initially for five years only. In 1952, its life was extended till the end of 1957 and it was finally placed on a permanent basis in 1957. The Act empowered the RBI and in certain cases Central Government to control and regulate dealings in Foreign Exchange, payments outside India, export and import of Currency Notes and Bullion, Transfers of securities between Residents and Non-Residents, acquisition of Foreign securities etc., The Act was later replaced by a more comprehensive legislation, the New Foreign Exchange Regulation Act 1973 came into force on Jan 1, 1974.

6) BANK OF CENTRAL CLEARANCE, SETTLEMENT AND TRANSFER :

The RBI acts as a clearing House of Member Banks. Since Banks keep cash reserves and deposits with the Central Bank, settlements between them can be more easily effected in the books of the Central Bank. By optimal use of money in banking operations, this particular function provides strength to the Banking System. In this way the RBI is operating as a Clearing House.

7) AGRICULTURAL FINANCE :

An Important Feature of the RBI Act was that it made Agricultural Finance the Banks Special Responsibility. This is indicative of the significance attached to the Agriculture sector which accounted for more than 50% of the National Income. The RBI has been providing tremendous supportive guidance in institutionalising the flow of credit to agriculture. To start with the attention was to provide a Co-operative credit structure for agriculture besides prescribing credit norms. Two special dunds under the captions "NATIONAL AGRICULTURAL CREDIT FUND" (LONG TERM OPERATIONS) and "NATIONAL AGRICULTURAL CREDIT "(STABILISATION FUND) were created with a view to strengthen the Co-operative Credit Structure. To answer the felt need of providing term Finance for Agricultural operations Agricultural Refinance Corporation was established by the RBI in the year 1963 Commercial Banks and Co-operative Banks were provided medium and long term loans by Agricultural Refinance Corporation. In order to highlight the promotional role being played by Agricultural Refinance Corporation the name was modified as Agricultural Refinance and Development Corporation in 1975. This Body subsequently in the year 1982 took the shape of National Bank for Agriculture and Rural Development (NABARD).

REGIONAL RURAL BANKS :

The RBI came out with a new experiment to spread the flow of credit in rural areas by

establishment of Regional Rural Banks in 1975 as an organization jointly owned by Central Government, the sponsoring, Commercial Banks and the State Government with a Share Capital in the Ratio of 50:35:15 respectively.

8) INDUSTRIAL FINANCE :

The RBI has played an active role in the field of Industrial Finance also. Its most notable contribution has been in establishing a broad Institutional framework to cater to the medium and long term needs of finance for the Industrial sector. Some of the Institutions in this category for the establishment of which the RBI took the initiative were (a) Industrial Finance Corporation of India (b) State Finance Corporations (c) Industrial Development Bank of India (d) Deposit Insurance and Credit Guarantee Corporation (e) Unit Trust of India.

For more than a decade IDBI and the UTI functioned as subsidiaries of the RBI. They were delinked from the RBI in 1976 pursuant to enactment of Public Financial Institution Laws Act 1975.

9) EXPORT FINANCE :

The RBI with the objective of increasing bank lending to the export sector and assisting the Export Trade in general has taken a number of measures. The most important of these has been the facility of Refinance to Scheduled Commercial Banks against their advances for exports. The RBI has been instrumental in the establishment of Export - Import Bank of India on Jan1, 1982 as a wholly owned Corporation of the Central Government under the Export -Import Bank of India Act 1981. The functions of Exim bank are to provide financial assistance to Exporters and Importers, act as the Principal Institution for Co-ordinating the working of another Institutions engaged in the field of International trade. Further EXIM Bank has introduced a number of services with a view to improve exports of the country. The Exim Bank of India can avail loans and advances from out of the National Industrial Credit Funds in terms of 17 (4G) read with see. 46 C (2) (C) of the RBI Act.

10) STRENGTHENING THE CO-OPERATIVE STRUCTURE :

The RBI has taken a number of steps to strengthen the Co-operative structure in the country. Many societies were operating at a loss with poor Management practices. The RBI took initiative to strengthen these societies by merging the weak societies. Providing necessary trading in Management Practices and injecting the required share capital in many cases.

11) COLLECTION OF DATA AND PUBLICATION :

The RBI has been empowered to collect a periodical Basis various information from the Banks and Financial Institutions as per various provisions of the RBI Act. All these Information and data are compiled and made available through publication of the following.

1) The Reserve Bank of India Bulletin
2) Credit Information Review
3) Annual Report of the RBI
4) Report on Currency And Finance
5) Report on Trends in Banking

12) PROMOTION AND DEVELOPMENT OF INSTITUTIONS :

The RBI played a vital role in the formation of the IDBI, National Bank for Agriculture and Rural Development Deposit Insurance and Credit guarantee corporation, State Financial Corporation, Export Import Bank of India. Apart from these the RBI set up the following Institutions.

1) The Discount and Finance House of India (DFHI)
2) The Securities Trading Corporation of India (STCI)
3) National Housing Bank
4) National Institute of Bank Management (NIBM)
5) North Eastern Institute of Bank Management (NEIBM)
6) The Institute of Banking Personnel Selection (IBPS)

The RBI has been instrumental in establishing an Institution under the name of INFRASTRUCTURE DEVELOPMENT FINANCE COMPANY (IDFC) with a view took provide impetus to infrastructure development as a Public Limited Company under the companies Act 1956 in January 1997 at Chennai.

13) TRAINING INSTITUTION :

In order to buildup and strengthen the skills of the workforce in the Reserve Bank of India as well as other Commercial Banks the RBI has established the following 3 Training Colleges.

1) Bankers Training College (BTC) at Mumbai.
2) College of Agriculture Banking (CAB) PUNE.
3) The RBI Staff College at Chennai.

Apart from the above the RBI also runs Zonal Training Centres for Training its own staff in Mumbai, Kolkata, Chennai and New Delhi.

14) LENDER OF THE LAST RESORT :

The Scheduled Banks are eligible for financial facilities from the RBI in return they owe certain obligations to the RBI. They are required to submit to the Bank a weekly statement showing their position in the form prescribed by the RBI Act. Failure in this regard will entail levy of penalty apart from prohibition of accepting fresh deposit during the period of default. The facilities which are provided by the RBI for the financial needs of the Banks are laid in Sec. 17 of the RBI Act. The facility is generally provided in the form of rediscount of eligible bills and loans and advances against eligible securities. The RBI takes into account the general profile of any Bank applying for such facilities and considers the nature of Banking transactions besides having a look into the kind of banking practices adopted by the Bank. Since the RBI is extending these facilities as something of a last report the Banks in need, it is commonly reckoned as “the Lender of last Resort”. Again, Sec. 18 (1) (3) provides for short term loans against any other securities which the RBI may consider sufficient. Also, the RBI has a right to suitably relax these conditions and is also empowered to grant advances to the Banks in times of emergency, despite the limitations/conditions if any.

15) REFINANCE OPERATIONS :

The very important functions of the RBI is that of providing re-finance facility with a view to improve liquidity as well as to improve the lending to specified channels of National Priority. The Policy measures have been changed from time to time and are usually announced through the Monetary and Credit Policy indicated by the RBI.

Usually re-finance facility is extended against Loans and Advances made by the Banks as well as Government Securities in some cases. As a part of rationalisation of CRR and of re-finance facilities from the RBI, sector specific re-finance facilities were either eliminated or rationalised to a considerable extent thus. Re-finance facility against Government Securities was withdrawn effective July 6, 1996.

1.19 MONETARY POLICY OF THE RESERVE BANK :

The Monetary Policy Framework has undergone changes over the recent period in response to reforms in the Financial sector and the growing external orientation of the Economy. The endeavour of the Policy has been to enhance the allocative efficiency of the Financial Sector, preserve financial stability and improve the transmission mechanism of Monetary Policy by moving from direct to indirect instruments.

Monetary Policy formulation for 2003-04 is based on a conditional expectations of real GDP growth at about 6.0 percent, inflation in the range of 5.0 to 5.5 percent. Projected expansion in broad Money (M2) at 14.0 percent and Non-Food Bank credit (including investments in Commercial papers, shares/debentures/bonds of PSUS and Private Corporate Sector) at 15.5 - 16.0 percent. The overall stance of Monetary policy for 2003 - 04 re-affirmed preference for a soft and flexible interest rate environment within a framework of Macro-Economic stability and centred on a close monitoring of inflation. In pursuit of its stance, the RBI would continues to modulate Market Liquidity to meet the Economy's requirements of Bank Credit. The stance of Monetary Policy was indicated through a 25 basis point cut each in the Bank rate and CRR. The Policy preference in regard to the Bank rate is to keep it stable in the near term. This was accompanied by gradual phasing out of sector specific refinance facility and rationalization of Interest rate structure at which Liquidity is available from the RBI.

1.20 REVIEW OF WORKING OF MONETARY SYSTEM CHAKRAVARTHY COMMITTEE REPORT :

In 1982, the RBI appointed a Committee with Prof. Sukhamoy Chakravarthy as its Chairman with the objective of reviewing the working of Monetary system in India. The Committee was required.

(a) To review critically the Monetary system in the context of the basic objectives of the planned development (b) to evaluate the various instruments of Monetary and Credit policies. (c) to assess the interaction of Monetary Policy and Public debt Management (d) to recommend suitable measures for improving the effectiveness of Monetary policy. The Committee submitted its report in April 1985 with the following main recommendations : (1) Objective of Price Stability (2) Monetary Targeting (3) Redefining Budgetary Deficit (4) Interest Rate Policy (5) Bank Credit Policy (6) Priority Sector Lending (7) Development of Money Market. The Government has accepted most of the recommendations of Chakravarthy Committee.

1.21 CENTRAL BANK AND RURAL FINANCE :

High variability in agricultural output and low productivity levels are symptomatic of the widening gaps in the Rural Physical and Social Infrastructure. Rural Infrastructure includes irrigation structures Agricultural research and Extension, Transport, Electricity, Storage structures, Telecommunication services and Market-yards directly enhances the productivity of Physical Resources. Social Infrastructure viz., drinking water supply systems, sanitation systems, health care services and Education, improve the efficiency of Human Capital. Various contributions of the RBI in promoting rural finance are as follows.

(1) For expanding and Co-ordinating Credit Facilities to the Rural Sector RBI has setup a seperate Agricultural Department.

(2) The RBI appointed the Rural Survey Committee in 1951 to explore the possibilities of expanding the Agricultural Credit, particularly through Co-operative Credit System.

(3) The RBI set up the National Agricultural Credit (Long Term Operations) and National Agricultural Credit (Stabilization) Fund to cates to the needs of rural people.

(4) Certain special Financial Institution such as the Agriculture Refinance and Development Corporation and National Bank for Agriculture and Rural Development was established.

(5) Apart from these measures the RBI provides useful advice to the Central and State Governments on matters relating to Rural Finance. It has developed a voluntary system of Inspection of Co-operative Banks.

1.22 RESERVE BANK AND INDUSTRIAL FINANCE :

Rapid Industrialisation in India requires (a) Adequate Provision of Long-Term Industrial Finance and (b) Promotion of Institutional Finance to the Small Scale Industries. The RBI has made a number of contributions to achieve these objectives.

(1) The RBI has setup a seperate Department called the Industrial Finance Department in 1957.

(2) The RBI does not directly participate Industrial Finance. But it has been instrument in the establishment of a number of Industrial Development Banks such as IDBI, IFCI, SFE's, SIDC's etc.,

(3) For providing loans to the Financial Institutions, the RBI has set up the National Industrial Credit (Long Term operations) Fund in July 1964.

(4) To encourage Institutional lending to the smalls scale Industries, the Govt. of India introduced the Credit Guarantee Scheme in July 1960.

(5) Small Scale Industries have also been recognises as a Priority Sector.

COMMERCIAL BANKS

Objective :

In this lesson we will study the origin and evolution of Commercial Banks. The Structure of Commercial Banking System as also various types of Banks will be elaborated. We will also have a look into the important provisions of Banking Regulation Act 1949. The Role and Functions of the Commercial Banks, as they have been changing over the years will also be looked into and also the emergence of new Private Banks.

STRUCTURE :

1.23 Introduction
1.24 Origin and Evolution of Commercial Banks
1.25 Commercial Banks
1.25.1 Structure of Commercial Banking System
1.25.2 Various Types of Banks - Public Sector / Private Sector / Foreign Banks
1.26 Changes in Role and Functions of Commercial Banks
1.27 Regulatory Framework
1.28 Provisions Relating to Opening of New Banks / Branches
1.29 Emergence of Private Banks - Role And Functions

1.23 INTRODUCTION :

Commercial Banks play an important role in directing the 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. Banks are these Financial Intermediaries collecting "Deposits" and lending "Loans". But now they are not only the purveyors of money but also the creators or manufacturers of money in a Financial System. It is the Banks who set the tempo of aggregate Economic activity in any Economy.

1.24 ORIGIN AND EVOLUTION OF COMMERCIAL BANKS :

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 word "BANCA" both meaning Bench. It is surmised that the word would have drawn its meaning from the practice of the Jewish Money Changers of Lombardy, 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 word gains Further relevance from the derivation of the word "BANKRUPT" from the French word "BANQUEROUTE" and the Italian word "BANCA - 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 chargers in the Temples of Jerusalem. In ancient Greece, around 2000 BC the Famous Temples of Ephesus, Delphi and Olympia were used as depositories for peoples surplus funds and these Temples acted as the Financial agents until Public confidence was destroyed by the spread of disbelief in the Region. Traces of credit by compensation and by transfer orders are found in Assyria, Phoenicia and Egypt before the system attained full development in Greece and Rome.

In India, the ancient Hindu scriptures refer to the money lending activities in the vedic period. In India during the RAMAYANA and MAHABHARATA 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 VYSYA Community. MANU, the great law gives of the time, speaks of the earning of interest as the Business of VYSYAs. The Banker in the Smriti period performed most of those functions which Banks perform in modern times, such as accepting of Deposits, granting secured and un-secured Loans, acting as their customer's bailee, 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 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 money 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 private own 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 practised in all countries including India, much earlier than the present type of Banking came on scene.

1.25 COMMERCIAL BANKS :

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 profile of a Bank or Banker in a very few words. Various Defitions of a Bank or Banker are as follows.

Dr. HERBERT L HERT in his "LAW OF BANKING" says "A Banker is 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.

Sir JOHN PAGET says that no person or body corporate or otherwise 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 un crossed 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 are does not state the various agency or other subsidiary services promoted by a modern Bank.

Sir JOHN PAGET 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 safety 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 facilitating exchanges".

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. They can be withdrawn by the depositors by cheque, draft or 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 per the provision of the Banking Regulation Act, every company willing to do Banking Business must obtain Licence from the RBI 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 be noted that money lenders are not Bankers.

Apart from the above activities carried out by a Banker a large number of activities as mentioned below continue to be performed by modern bank.

A reference to Sec. 2 of Singapore Banking Act will also indicate almost the same concepts. The Act defines Banking Business as the Business of receiving money as current or deposit Account, paying and collecting cheques by or paid in by customers, the making of advances to customers and

includes such other business as the authority (monetary authority of Singapore) may prescribe for the purpose of this Act.

A company to be reckoned as Banking company must carry out the two acid test functions of (a) accepting deposits and (b) Lending or Investing these Deposits. Thus the main Business of a Bank is that of an intermediary between the saving and investment operations of the public. It collects the savings of the surplus spenders and channelises them to the deficit spenders - itself serving simply as a middle man. "Infact it is not really the Banks which lend except the Name. The Banks are intermediaries. They bring borrowers and lenders together. And the lenders are the Bank depositors all the borrowers are then the debtors through the Banks as intermediaries of all the depositors" (HARRY GUNNISON BROWN).

BUSINESS OF BANKING COMPANIES :

Apart from Pure Banking Business of collecting and safe keeping funds in the shape of Deposits and making of advances and Investments, a modern Banks provides a variety of ancillary services which could be classified into two categories "AGENCY SERVICES" and "GENERAL UTILITY SERVICES" Sec. 6 of the Banking Regulation Act list the following activities as those in which a Banking company engage in.

(A) MAIN FUNCTIONS :

1) The borrowing, raising or taking of Deposits of money.
2) The lending or advancing of money either upon or without security.
3) The drawing, making accepting, discounting, buying, selling, collecting and dealing in Bills of Exchange, Hundies, Promissory Notes, Coupons drafts, Bills of Leading, Railway Receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not.
4) The granting and issuing of letters of credit, travelers cheques and Circular notes :
5) The buying, selling and dealing in bullion and species;
6) The buying and selling of foreign exchange including foreign bank notes;
7) The acquiring, holding, issuing on Commission, underwriting and dealing in stock, funds, shares, debentures, debenture stocks, bonds, obligations, securities and investments of all kinds.
8) The purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents of others;
9) The negotiating of loans and advances;
10) The receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise;
11) The providing of safe deposit vaults for custody of valuables of customers and
12) The collecting and transporting of money and securities.

The kind of services which we can considers "subsidiary services" to the main business of banking [listed above] can be listed as under

a) Bank;
b) may act as agent for any government or local authority or any other person or persons but it cannot act as a managing agent or secretary and treasurer of a company;

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

d) may effect, insurance, guarantee, 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;

e) may carry on and transact every kind of guarantee and idemnity business;

f) may manage, sell and realise any property which may come into it's possession in satisfaction of it's claims;

g) may acquire, hold and deal with any property or any right, title or entrust therein which forms the security for any loans or advances sanctioned;

h) may undertake and execute trust;

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

j) 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.

k) may acquire, construct, maintain and alter any building or works necessary for it's purposes.

l) may sell, improve, manage, develop, exchange lease, mortgage, dispose off or otherwise deal with any of it's properties and rights;

m) 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;

n) may do all such other things as are incidental or conductive to the promotion or advancement of it's business.

o) may engage in any other form of business which the Central Government specifies to be lawful. The last two are general causes 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 ancillary services, we can furnish the services falling under the caption "AGENCY SERVICES" and "GENERAL UTILITY SERVICES".

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, 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 negotiating 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, traveller's 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 [b]}.

10) Contracting for Public and Private loans {under [h]}.
11) Under-taking and executing trusts {under [c]}.
12) Under-taking the administration of estates as executor, trustee or otherwise {under [i]}.

GENERAL UTILITY SERVICES :

1) The receiving of all kinds of bonds scrips or valuables on deposit or for safe custody or otherwise {under [a]}.
2) The providing of safe deposit vaults {under [a]}.
3) The lending of money for the purpose of issuing stocks, shares, debentures etc., {under [d]}.
4) the carrying on and transacting every kind of guarantee and indemnity business {under [e]}.

Apart from these various kinds of services that are being extended by commercial banks in our country banks of late have been vying with each other in introducing newer kinds of services mostly customised to the needs of different segments of customers, more so in the context of financial sector reforms. Banks have been permitted to set up money market mutual funds. Some banks have entered into venture capital financing. Housing Finance has also been taken as a focussed 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 and 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. The case with which money can be obtained from banks by businessmen acts as a stimulus to productive enterprise. They are also benefited by the advice and information which banks are always ready to place at their disposal. By the choice they exercise as to the persons who will be offered financial assistance and accommodation, banks are in a position to influence the directors into which the capital of a country will flow. 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 and is thus imbued with a feeling of security.

In Gilbart's words, bankers act as "Public conservators of the Commercial Vairtues". In their own interest "they encourage the industrious, the prudent, the punctual and the honest - while they discountenance the spendthrift and the gambler, the liar and the knave. They hold out inducements to uprightness, which are not disregarded by even the most abandoned. There is many a man who would be deterred from dishonesty by the frown of a banker, though he might care but little for the admonitions of a bishop". Its therefore no exaggeration to say that a country having a sound and efficient banking system is possessed of one of the essential foundations of prosperity.

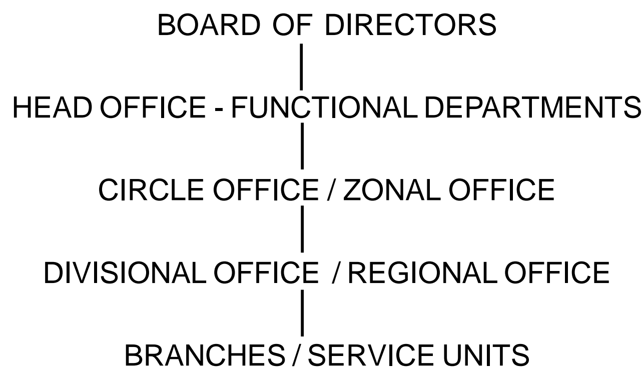
STRUCTURE OF A COMMERCIAL BANK :

In the Indian Banking scenario, we have the system of Branch Banking, otherwise called Chain Banking in operation, as against unit Banking. In the case of Unit banking prevalent mostly in USA, the bank's operations are in general confined to a single office or in very rare cases, restricted to branches within a strictly limited area.

In the case of chain banking a single bank operates in the country through a country - wide network of branches. Depending on the size of the bank, the areas in which they operate vary. This is the system being followed in UK. Banks like Midland Bank Ltd., Cloyds and Barclays have got a large network of branches.

In Indian Banking scenario also this type of Chain Banking is in operation. Almost the major component of the banking system is by way of Chain Banking and the banks have a network of branches spread far and wide across the country or in restricted, compact, geographic areas. Even Regional Rural banks operate in specified regions.

The structure of a commercial bank can broadly be pictured as under ;



In the above structure, there is a particular department/wing at Head Office level as also at circle office to take care of and focus on various individual facts of Banking such as Credit, Deposits, Recovery, Foreign Exchange, Premises, Personnel and General Administration.

Branches have been categorised into several kinds depending upon the volume of business transacted by them as exceptionally Large Branch, Very Large Branch, Medium Branch and Small Branch.

In the wake of recent changes brought through the Narasimham Committee Recommendations, restructuring has been attempted in a few Banks who have abolished a few fairs in administration making the operational units report directly to Zonal Office/Head Office.

Suggestions are a foot as to consolidation of and mergers of Banks with a view to make the Indian banks have a size comparable to Foreign Banks, so that it will be easier to face the increasing global competition.

1.25.1 STRUCTURE OF COMMERCIAL BANKING SYSTEM :

As seen elsewhere the indian Banking System is composed of different entities each with a specific role to play and specific segment to eater to. It may not be appropriate to classify these constituents as indigenous and modern or organised and unorganised sectors. A classification based upon its role and functions will give a clearer view.

Before having a took into the structure of the Commercial banking system let us quickly recount the structure of the banking system itself based upon the role and functions.

The constituents of the Indian banking system can be listed as under.

I) COMMERCIAL BANKS

a) Indian Commercial banks - Scheduled and non-scheduled
b) State Bank of India and it's Associates
c) Foreign banks

II) RURAL FINANCING AGENCIES

a) Co-operative Banks
b) Land Development Banks
c) Regional Rural Banks
d) National Bank for Agriculture and Rural Development

III) DEVELOPMENT FINANCE INSTITUTIONS

a) Industrial Finance Corporation of India
b) Industrial Credit and Investment Corporation of India
c) Industrial Reconstruction Bank of India
d) State Financial Corporations
e) Industrial Development Bank of India
f) Small Industries Development Bank of India
g) Export Import Bank
h) National Housing Bank

IV) NON-BANKING FINANCIAL INTERMEDIARIES

a) Life Insurance Corporation of India
b) General Insurance Corporation of India
c) Unit Trust of India
d) Merchant Banking Institutions
e) Mutual Funds

V) POST-OFFICE SAVINGS BANKS

VI) THE RESERVE BANK OF INDIA

Coming now to Commercial Banks we can describe the structure of Commercial Banking as under

1) Nationalised Banks
2) Private Sector Banks
    a) Old Private Sector Banks
    b) New Private Sector Banks
3) Foreign Banks

1.25. 2 VARIOUS TYPES OF BANKS - PUBLIC SECTOR - PRIVATE SECTOR - FOREIGN BANKS

PUBLIC SECTOR BANKS

The term Public Sector Banks by itself connotes a situation where the major/full stake in the banks are held by the Government.

Excepting the Reserve Bank of India which was nationalised in 1949 there was no other bank which had the tag of Public Sector Bank till 1969. With the nationalisation of banks brought in by

Banking Companies [Acquisition and transfer of under takings] Act, 1970, fourteen banks each of which had a level of more than Rs. 50 crores in time and demand liabilities acquired the character of nationalised banks effective from 19th July 1969. The list of these fourteen banks has already been given earlier. This was subsequently followed by nationalisation of six more Private Sector Commercial Banks, each of which had crossed the deposit limit of Rs. 200 crores.

In the year 1980, effective from 15.4.1980. The list of these six banks has also been furnished earlier.

Thus, as on date there are totally 19 nationalised banks existing as on date, consequent to the merger of New Bank of India with Punjab National Bank in September 1993.

Consequent to an Amendment made to the Banking Companies [Acquisition and transfer of undertakings] Acts 1970 / 1980 in 1994. Nationalised banks have been permitted to offer their equity shares to the Public to the extent of 49% of their capital. Accordingly, the following nationalised banks offered shares to the Public.

a) Corporation Bank
b) Bank of India
c) Bank of Baroda
d) Oriental Bank of Commerce
e) Dena Banks

A part from the above, the following banks coming under the State Bank of India group, {where also the majority share holding is held by the Government of India} have also offered shares to the public

1) State Bank of India
2) State Bank of Mysore
3) State Bank of Travancore
4) State Bank of Bikaner and Jaipur

To put it in a nutshell, the Public Sector banks comprise 19 nationalised banks as well as State Bank of India and seven associates.

PRIVATE SECTOR BANKS :

By Private Sector Banks we mean those banks where equity is held by Private Shareholders that is to say there is no Government holding of the Equity shares. This category of Banks also occupies a significant position in the Banking Scenario. There are already 25 Private Sector Banks operating in our country for quite some time. These Banks are listed under

1) The Vysya Bank Ltd.,
2) The Federal Bank Ltd.,
3) The Jammu & Kashmir Bank Ltd.,
4) Bank of Rajasthan.,
5) Karnataka Bank Ltd.,
6) The South Indian Bank Ltd.,
7) The United Western Bank Ltd.,
8) Bank of Madhura Ltd.,
9) The Cathloic Syrian Bank Ltd.,

10) The Karur Vysya Bank Ltd.,
11) Tamilnadu Mercantile Bank Ltd.,
12) The Lakshmi Vilas Bank Ltd.,
13) The Sangli Bank Ltd.,
14) The Dhanalakshmi Bank Ltd.,
15) Development Credit Bank Ltd.,
16) Bharat Overseas Bank Ltd.,
17) City Union Bank Ltd.,
18) The Banares State Bank Ltd.,
19) The Nedungadi Bank Ltd.,
20) Lord Krishna Bank Ltd.,
21) Bareilly Corporation Bank Ltd.,
22) Nainital Bank Ltd.,
23) The Ratnakar Bank Ltd.,
24) The Ganesh Bank of Kurundwad Ltd.,
25) SBI Comm & Int. Bank Ltd.,

There has been a growing presence of Private Sector Banks, more so after the introduction of Financial Sector Reform from 1991. Six New Private Banks listed as under were issued Licences in 1994-95 and Commenced operations during the same year.

1) UTI Bank Ltd.,
2) INDUSTRIAL BANK LTD.,
3) ICICI BANKING CORPORATION LTD.,
4) GLOBAL TRUST BANK LTD.,
5) CENTURION BANK LTD.,
6) HDFC BANK LTD.,

Again during 1995-96 the following 3 banks were issued the licences and commenced their operations.

1) TIMES BANK LTD.,
2) BANK OF PUNJAB LTD.,
3) IDBI BANK LTD.,

The size of the Private Banks in our country as on date is furnished here under :

1) Number of Private Banks in operation 35.
2) Number of Bank Branches of Pvt. Sector Banks 4, 473.
3) Amount of Deposits - Rs. 44, 692 Crores
4) Amount of Advances - Rs. 34,674 Crores

1.26 CHANGES IN ROLE AND FUNCTIONS OF COMMERCIAL BANKS :

There has been a tremendous change over the years in the very meaning of Banking. Banking earlier was purely restricted to borrowing money as deposits, with a view to lending them as advances. Thus the main facts were confined to the acceptance of deposits and lending of loans. With the growth of Indian Economy and also as an off-shoot of reform measures, Banks have come to take upon themselves, various other activities which may not measure up to this old definition of Banking. These activities include :

1) Investment Counselling
2) Investment Banking
3) Mutual Fund
4) Project Appraisal
5) Merchant Banking Services
6) Taxation Advisory Services
7) Executor Trustee Services
8) Housing Finance Activities
9) Segment wise Specialised Branches
10) Credit Card Services
11) Computer Software Services
12) Forex Consultancy Services
13) 24 Hours Banking
14) ATM Services
15) Transaction of Government Business
16) Securities Trading
17) Money Market Mutual Funds
18) Factoring
19) Leasing and Hire Purchase
20) Gold/Silver/Platinum Trading
21) Venture Capital Financing

These activities are either being pursued by seperate departments of the Banks or by seperately floated independent subsidiaries formed for undertaking such activities exclusively.

In the days to come, Banking sector will witness a dramatic change. The Internet Banking will bring a great revolution possibly usering “BRANCHLESS BANKING”.

1.27 REGULATORY FRAME WORK :

The various dimensions of the Regulatory frame Work of the Banking System are

1) Licensing of Banks
2) Capital Reserves and Liquid Assets
3) Branch Licensing Policy
4) Inspection of Banks
5) Control Over Methods of Operation
6) Control Over Management
7) Audit of Annual Accounts of Banks
8) Control Over Amalgamations and Schemes of Arrangements and Reconstruction of Banks.
9) Supervision of Banks In Liquidation.
10) Credit Information Service

1.28 PROVISIONS RELATING TO OPENING OF NEW BANKS / BRANCHES :

In order to introduce greater competition in the Banking System, the RBI 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 RBI Act 1934 and the Banking Regulation Act 1949 and also the directives. Institutions/ guidelines and advice given by the RBI.

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 percent of total voting rights as stipulated by the RBI Act 1949.

e) The New Banks shall not be allowed to set up a subsidiary or Mutual Fund for atleast 3 years after establishment and

f) The Banks shall take use of Modern Infrastructural facilities to provide good customer service as also institute a high powered customer grievances cell to handle customer complaints.

In line with the Bhandari Committee's recommendation, the Branch Licensing Policy for RRB's was modified in June 1985 as follows -

a) To RRB's were freed form the Service Area obligations and were given freedom to relocate their loss making branches preferably within the same block or convert them into satellite mobilie offices.

b) Two loss making branches of the same RRB within 5 Kms area were permitted to merge

c) RRB's with Service Area obligations were free to relocate loss making branches at "Specified Centres" within their area subject to the conditions cited above.

Apart from these provisions relating to licensing of Commercial Banks and Regional Rural Banks, the RBI came out with a Licensing Policy in respect of Urban Co-operative Banks in 1993.

1.29 EMERGENCE OF PRIVATE BANKS - ROLE AND FUNCTIONS :

The whole profile of Indian Banking is under going a metamorphosis. These Private Banks have given a decided focus on the following aspects of their activities.

1) Corporate Goverence.
2) Faster adoption of Technology.
3) Greater focus on Customer Service.
4) Aggressive marketing of Schemes and Products.
5) Introduction of innovative products/services/mostly customised to the needs of various individual customers/segment of customers.
6) Stiff competitive spirit in the Banking Industry.
7) Spread of Credit and Culture.

CO-OPERATIVE BANKS

objective :

After going through this lesson you should be able to understand therRole and functions of Co-operative Banks.

STRUCTURE :

1.30 Introduction
1.31 Co-operative Banks
1.32 Structure of Co-operative Banking System
1.33 State Co-operative Banks At State Level
1.34 Evaluation of Performance of Co-operative Banks
1.35 Recent Changes

1.30 INTRODUCTION :

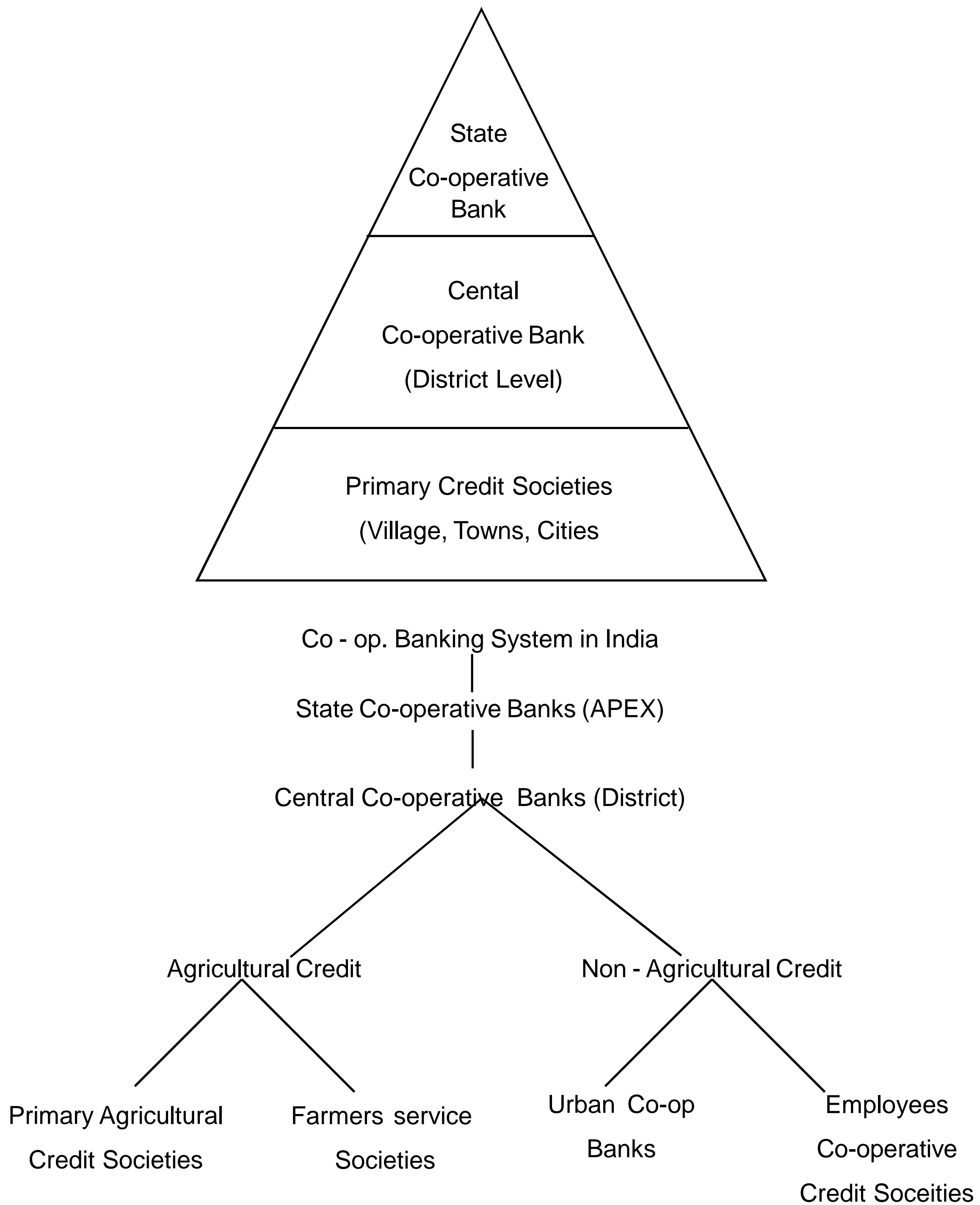
Co-operative Banks constitute an important place in the Indian Banking System. This segment has grown in recent years, especially with a view to address the problems of rural People.

1.31 CO-OPERATIVE BANKS :

The Co-operative Banks play an important role in the Indian Financial System, especially at the village level. The growth of co-operate Movement Commenced with the passing of the Act 1964, which officially launched the movement in India. The Act provided an easy legal framework for their formation as well as goverence by making the Co-operative Banks from the complicated provisions of the Indian Companies Act. The Act as it was conceived did not have provisions with respect to the Registration of the Co-operative Banks as well as any controlling aspects over these Banks. These Lacunae were removed by the Act of 1912. Again, the movement gained momentum with the enactment of Government of India Act of 1919 under which "CO-OPERATION" became a provincial state subject. The Act of 1912 has been replaced by Provincial Acts in Mumbai and Chennai in 1925 and 1931 respectively. There have been attempts in recent times to strengthen and consolidate the gains of the Co-operative Movement.

Generally speaking in many countries other than India, Co-operative Movement arose spontaneously from the participation of the people directly in our country. The Government gave the lead and participated and propagated the Co-operative movement. The RBI has been playing a very active role in the formation, promotion of Co-operative Banks as well as suppose - activities extended to them. The Co-operative Principle of Managing Finance in India serves as a via media between sophisticated Institutions like modern Commercial Banks on the one hand and unscrupulous money lenders on the other. Despite the tremendous and vast network of the Commercial Banks, more so of the nationalised sector, Co-operative Banking remains an effective instrument of credit delivery in the case of rural borrowers even to this day.

1.32 STRUCTURE OF THE CO-OPERATIVE BANKING SYSTEM :



1.33 STATE CO-OPERATIVE BANKS AT STATE LEVEL :

The State Co-operative Banks as such assumes the key position in the Co-operative credit structure. They undertake both mobilisation of resources as well as proper deployment among various sectors. The RBI can reach the cultivators only through the medium of State Co-operative Banks. Again State Co-operative Banks carryout the role of intermediaries between the Money Market and Central Co-operative Banks in the sense that the State Co-operative Banks because of their location have got easy access in the urban rich, which is not available in the case of Central Banks. But difficulty they act as financing agencies as well as to the Central Banks and act as the balancing centres that is to say they balance the excess and deficiency in the resources of the Central Banks because Central Banks are not allowed to lend to each other.

The Share Capital of State Co-operative Banks is contributed partly by affiliated Central Banks and partly by individuals who play an important part in its management. The State Co-operative Banks some times also function as Central Banks in places where there are no local Central Banks. The resource structure of State Co-operative Banks consists of the following.

1) Share capital
2) Reserve fund
3) Various kinds of deposits similar to those of Central Co-operative Banks
4) Short term loans, Cash credits and Over drafts from SBI and other Banks.
5) Deposit of surplus funds of Central Banks affiliated to them

They lend to the Primary Agricultural Credit Societies through affiliated Central Banks except in areas which have no Central Banks of their own funds in this way flow from State Co-operative Banks to Central Co-operative Banks, then to Primary Agricultural Credit Societies and finally to the individual borrowers. The RBI provides support in cases of temporary shortage of funds. The State Co-operative Banks as such do not have powers of control or supervision over the Central Co-operative Banks except as a monitoring mechanism in granting loans.

1.34 EVALUATION OF PERFORMANCE OF CO-OPERATIVE BANKS (Strengths And Weaknesses) :

There has been really a marked improvement in the progress of CO-OPERATE credit movement in our country aided frequently by the Government support and the intervension of the Reserve Bank of India. Co-operative credit has been expanding over the years although it is a question of doubt if the entire credit needs of the rural borrowers in the respective areas have been catered to by the Co-operative Credit. Further, the problem of overdues has been posing a very serious threat to the Co-operative credit movement and in some cases even creating problems of even sheer survival.

The Co-operative Credit Movement despite its making in roads into rural setting, has been best by the following deficiencies :

a) Delay in sanction of loans
b) Provision of Inadequate Credit
c) Reducing spread between income and expenditure
d) Excessive control by bureaucracy
e) Inadequate training to the work force

f) Lack of Co-ordination between Commercial Banks, RRBs and Co-operative Banks;
g) Lack of Co-ordination between agricultural and Co-operative departments;
h) Ineffective audit over the operations;
i) Improper organisational structure;

The Reserve Bank of India has been pursuing vigorously various measures based upon the findings of different Committees on rural credit with a view to strengthen the Co-operative Movement besides consolidating the gains achieved so far. Even to this day, Co-operative movement is playing a very significant role in the domain of rural credit. We shall have an overview of recent changes introduced in this regard.

1.35 RECENT CHANGES :

Co-operative Credit Institutions occupy an important position in the Financial System in terms of reach, volume of operations and objectives. The Co-operative Credit System can be broadly classified into Urban Banks and Rural Co-operative Banks. The Rural Co-operatives play a pivotal role in the rural credit delivery system whereas the Urban Co-operative Banks aim at mobilising savings from the middle and low income groups and purvey credit towards the weaker sections. UCBs and Rural Co-operative Credit Banks are supervised by the Reserve Bank and the NABARD respectively. Both are regulated by the State Governments in regard to certain types of functions.

Since 2001-02, the RBI has undertaken a series of measures directed towards strengthening the financial position of the UCBs, such as applying capital adequacy standards. Prescribing an Asset - Liability Management Frame Work, enhancing the proportion of holding of Government and other approved securities for the purpose of SCR, restriction on Bank Finance against the security of Co-operative shares and debentures. During 2002-03 these efforts were reinforced.

Fully/partially computarised UCBs were advised to introduce an Electronic Data Processing (EDP) audit system. All UCBs are required to have an audit system. All UCBs are required to have audit committee of the Board for overseeing and providing directions to Internal Audit/Inspection machinery of the UCB. Based on the Joint Parliamentary Committee (JPC) which enquired into the irregularities in Capital Markets. Urban Co-operative Banks were advised that -

1) They have to take action for removing the deficiencies pointed out in the RBI inspection reports within a maximum period of 4 months from the date of Inspection report and provide a certificate to that effect, failing which penalty will be imposed for non-compliance.
2) The Audit Committee of the Board of Directors of UCBs should review the Internal Audit/ Statutory Audit reports and the RBI Inspection reports and monitor action taken and
3) UCBs should appoint Concurrent Auditors. As an March 31, 2003 there were 2,104 UCB's. At end March 2003, the total number of scheduled UCBs was 56 spread over six states. Andhra Pradesh, Goa, Gujarat, Karnataka, Maharashtra and Uttar Pradesh.

REGIONAL RURAL BANKS (RRBs)

objective :

After going through this lesson you should be able to understand the role and functions of Regional Rural Banks.

STRUCTURE :

1.36 Introduction
1.37 Rural Banking System RRB
1.38 Management, Regulation of Regional Rural Banks
1.39 Evaluation of Performance of RRBs. Strength and weakness

1.36 INTRODUCTION :

In 1976, the Parliament brought the Legislation the Regional Rural Banks Act 1976, which provided for the incorporation, regulation and winding use of RRBs. The Act became effective from 26th September 1975 (based on the ordinance issued in 1975). The objectives of the Act as clearly mentioned in the Preamble to the Act, are as under -

"An Act to provide for the incorporation, regulation and winding up of Regional Rural Banks with a view to developing the rural economy by providing for the purpose of development of agriculture. Trade, Commerce Industry and other productive activities in the rural areas, credit and other facilities particularly to the small and marginal farmers, agricultural labours, artisans and small entrepreneurs and for matters connected therewith and incidental there to".

1.37 RURAL BANKING SYSTEM :

As per Section 5 of the Act, the authorised Capital of each Regional Rural Bank shall be Rs. 5 Crores divided into five lakhs of fully paid up shares of Rs.100 each provided that the Central Government may, after consultation with the National Bank and the Sponsor Bank increase or reduce such authorised capital. So however that the authorised capital shall not be reduced below Rs. 25 Lakhs.

As per Sec. 6, the issued capital of each Rural Bank shall in the first instance be such as may be fixed by the Central Government but it shall in no case be less than Rs. 25 Lakhs or exceed/crore of this 50% shall be subscribed by the Central Government and 35% by the Sponsor Bank. The issued capital may be increased by the Board of Directors after consultation with the National Bank, the concerned State Government and the Sponsor Bank and with the prior approval of the Central Government. The Additional Capital shall also be subscribed in the proportion.

1.38 MANAGEMENT AND REGULATION OF RRB's :

As per Sec. 8 the general superintendence direction and Management of the affairs and Business of a RRB vests in the Board of Directors who may exercise all the powers and discharge all the functions which may be exercised or discharged by the Regional Rural Bank. In discharging its functions, the Board shall act on Business Principles and shall have due regard to public interest.

As per Sec. 18 (1) every Regional Rural Bank shall carry on and transact the business of banking as defined in clause (b) of the Sec. 5 of the Banking Regulation Act 1949 (10 of 1949) and may engage in one or more forms of business specified in sub-section (1) of Sec. 6 of that Act. As per Sub Section (2) of Sec. 18 without prejudice to the generality of the Provisions of Sub Section (1) every Regional Rural Bank may in particular undertake the following types of Business :

a) The granting of loans and advances, particularly to small and marginal farmers and agricultural labours, whether individually or in groups and to Co-operative Farming Societies, Primary

Agricultural Credit Societies or Farmer's Service Societies for agricultural purposes or agricultural operations or for other purposes connected therewith.

b) The granting of loans and advances particularly to artisans, small entrepreneurs and persons of small means engaged in Trade, Commerce or Industry or other productive activities within the notified area in relation to the Regional Rural Bank.

REGULATION :

Besides, the Reserve Bank which is regulatory authority for the Regional Rural Bank in accordance with the Provisions of the Banking Regulation Act 1949. The Banking Regulation Act empowers NABARD referred to in the Act as "National Bank" to undertake the Inspection of RRB. A RRB seeking permission of the Reserve Bank for opening Branches etc., has to obtain the recommendation of Nabard. The returns and documents to be furnished under the Banking Regulation Act to the Reserve Bank are also to be forwarded to the NABARD in case of Regional Rural Banks.

1.39 EVALUATION OF PERFORMANCE OF RRBS STRENGTH AND WEAKNESS :

Though RRBs have been making a great contribution in the area of rural credit right from inception, still they do suffer from a number of weaknesses such as :

1) Poor Capital Structure
2) Decreasing Profits
3) Increasing Over heads
4) A lack of Effective Co-ordination between Commercial Banks, Co-operative Banks and RRBs in the area of their operation.

To strengthen the structure of RRBs by addressing these manifold weakness. BHANDARI COMMITTEE AND BASU COMMITTEE have made a number of recommendations. Besides the RBI has been consciously taking a number of supportive measures to ensure that the RRBs are revived on a sound footing. (1) Important Banking indicators of RRBs 1991 to 2001 and (2) Financial Performance of RRBs for 1999 - 2000 and 2000 - 2001 is mentioned below.

INDIGENOUS FINANCIAL AGENCIES

objective :

After going through this lesson you should be able to understand the origin, role and functions of Indigenous Financial Agencies, different kinds of Agencies, regulatory Frame work, recent development etc.

STRUCTURE :

1.40 Introduction
1.41 Origin, Role and Functions of Indigeneous Financial Agencies
1.42 Various kinds of Indigeneous Financial Agencies
1.43 Supervisory and Regulatory Framework
1.44 Recent Developments

1.40 INTRODUCTION :

In this Lesson, we shall dwell upon an important segment of the Financial System of a country

namely Indigenous Financial Agencies or popularly known as Non-Banking Financial Institutions. The role played by these Institutions in recent years has been receiving great attention and these Institutions have developed as an effective competitive mechanism to the Commercial Banking structure, facilitating a rapid growth of Economy and Industry.

1.41 ORIGIN, ROLE AND FUNCTIONS :

The Indian Financial System has many diverse segments each catering to the demands of a choosen segment of the Economy. Among these segments the role played by the entity known as Indigenous Financial Agencies (IFA) or Non-Banking Financial Services (NBFS) has been growing in a very significant way. Till recently they have been complementing the services provided by the Commercial Banks and competing with them.

By and large, the evolution of Financial System has in general been a slow and gradual process in any Economy. But even in this process NBFCs have been making rapid strider. The fast growth depends upon the particular staze of the Economy. To quote for example United States of America witnessed a splendid growth during the first five three decades of the last century, as could be evident from the fact that two of the top 5 Commercial Leaders are Indigenous Financial Agencies. In our country the presence of Indigeneous Financial Agencies has been increasing in a very spectacular way. It is estimated that there are more than 50,000 IFAs operating in our country. This fast growth could be attributed to the following factors -

a) While Banking System has been subject to comprehensive and stricter regulations IFAS did not have a rigid regulatory framework till very recently.

b) Simple procedure and lesser response time to meet the needs of the customers.

c) Higher rates of interest offered to the depositors.

d) Increasing degree of customer friend lines in all activities.

e) A high degree of innovation in coming out with newer and customer oriented services/products. The activities can be broadly classified into two categories as under -

1) Found based activities
2) Fee based activities

Found Based Activities	**Fee based Activities**
1. Equipment leasing and hire purchase financing for corporate and institutional Client	1. Issue Management
2. Consumer Finance	2. Portfolio management
3. Bill Discounting	3. Corporate counselling
4. Loans / investments	4. Project counselling
5. Venture Capital	5. Loan / Lease syndication
6. House Finance	6. Arranging foreign collaborations
7. Factoring	7. Advising on Acquisition and Merger
8. Equity Participation	8. Helping in institutional placement services
9. Bought out deals	9. advising on capital resturcturing

10. Short term bridge loans / promoter fonding
11. Financing against securities
12. Inter corporate loans

10. forex advisory services

An almost comprehensive definition of a NBFC has been provided in Section 45 [1] of the Reserve Bank of India Act, 1934 having been introduced by the Reserve Bank of India (Amendment) Act, 1997, with effect from 1997. We have already discussed this earlier in Chapter No. 111. However, for easy reference let us recapitulate once again, the definition

According to this clause

"Non-Banking Financial Company" means -

[i] a Financial Institution which is a company;

[ii] a non-banking institution which is a company and which has as it's principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner.

[iii] such other non-banking institution or class of such institutions, as the bank may, with the purpose approval of the Central Government and by notification in the official Gazette, specify.
["A company means a company registered under the Companies Act and includes a Foreign Company" Sec. 45 (1) [aa] RBI Act, 1934].

Financial Institution means (as per Section 451 (c) of RBI Act. 1934) any non-banking institution which carries on as it's business or part of it's business any of the following services namely :

i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own

ii) the acquisition of shares stock, bonds, debentures or securities issued by a Government or Local authority or other marketable securities of a like nature.

iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of Section 2 of the Hire Purchase Act, 1972 (26 of 1972).

iv) the carrying on of any class of insurance business

v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any state, or any business, which is similar there to;

vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum of otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes of gifts, whether in cash or kind, or disbursing monies in any other way to persons from whom monies are collected or to any other person, but does not include any institution which carries on as it's principal business

a) Agricultural operations; or

aa) Industrial activity; or

b) the purchase or sale of any goods (other than securities) or the providing of any services; or

c) the purchase, construction or sale of immovable property. So, however, that no portion of the income of the institution is derived from the financing of purchases, constructions of sales of immovable property by other persons.

EXPLANATION :

For the purposes of this clause "Industrial Activity" means any activity specified in subclauses (i) to (xviii) of clause (c) of Section 2 of the industrial development bank of India Act, 1964 (18 of 1964). A "non banking institution" has been defined in clause (c) of Section 451, to mean a Company Corporation or Co-operative Society.

1.42 VARIOUS KINDS OF INDIGENEOUS FINANCIAL AGENCIES :

Presently the following are the Indigeneous Financial Agencies that are in vogue in our country. (1) Loan Companies or LCs (2) Investment Companies or ICs (3) Hire Purchase Finance Companies or HPFCs (4) Lease Finance Companies or LFCs (5) Housing Finance Companies or HFCs (6) Mutual Benefit Financial Companies or MBFCs (7) Residurary Non-Banking Companies or RNBC's (8) Merchant Banks (9) Venture Capital Funds (10) Factors (11) Credit Rating Agencies (12) Depositories and Custodial Services.

1.43 SUPERVISORY AND REGULATORY FRAMEWORK :

The basic factor contributing to the Phenomenal growth of Indigeneous Financial Agencies has been the absence of rigid regulatory framework. The regulation was felt on two counts.

a) Protecting the Interests of the depositors.

b) Providing clear monetary and credit policy so as to strengthen the Financial System.

Several Committees and groups have made a detailed study about the role and operations of Indigeneous Financial Agencies. They are listed below :

1) BHABATOSH DATTA STUDY GROUP (1971)
2) JAMES RAJ STUDY GROUP (1975)
3) CHAKRABARTY COMMITTEE (1987)
4) NARASIMHAM COMMITTEE (1991)
5) SHAH COMMITTEE (1992) AND
6) KHANNA COMMITTEE (1996)

Specifically, the recommendations of Shah Committee and Khanna Committee provide the basic contours of ended the following :

1) Abolition of category wise classification of Finance Companies
2) Application of uniform regulation for all finance companies
3) Focussing Regulatory attention on large size companies
4) Compulsory Registration of all deposit taking companies providing a cut off point and emphasizing the regulation relating to the assets side
5) Setting up capital adequacy standards and prudential norms
6) prescription of provision for bad and doubtful debts
7) Compulsory annual credit rating
8) Auditors to discharge greater responsibilities in auditing regulatory compliance

The recommendations of Khanna Committee laid emphasis on the Supervisory Framework by way of on-site supervision and off-site supervision for a healthy growth.

1.44 RECENT DEVELOPMENTS :

The RBI (Amendment Act, 1997) has considerably added force to Regulatory Employment of RBI. These are the recent developments.

1) Indigenous Financial Company has been clearly defined. Institutions carrying on Agricultural or Industrial Activity as their principal are excluded from the definition.
2) The minimum net fund of Rs. 25 Lakhs and RBI regulation have been prescribed as entry point Norms.
3) The existing companies have also to apply for registration by July 8, 1997. Their Business can however be carried on unless registration is refused.
4) The RBI has the powers to cancel Registration. However the companies have power to appeal to the Central Government.

DISCOUNTING HOUSES

Objective :

In this lesson you are able to understand the creation and working of the Discounting and Finance Houses of India which is expected to play an active role in developing Primary and Secondary Markets.

STRUCTURE :

1.45 Introduction
1.46 Function and working of Discount Finance Corporation
1.47 Discounting Service

1.45 INTRODUCTION :

The efficiency, Stability and minimisation of the risk of Insolvency of Financial Institutions and Banks require Institution, arrangements and services for the best liquidity management in Financial Markets. Traditionally Central Banks in all countries have been helping the Money Market in this context by providing discounting and refinance facilities. The term “Discounting” now often refers to lending not only against Bills of Exchange but also in the form of direct loans and Advances. The Discount Finance House of India was set up in April 1988 as a specialised Institution to operate in the Discount Market. It is similar to Discount House in the U.K. The DFHI is a Joint Stock Company owned by the RBI, Public Sector Banks and Financial Institutions. It plays a developmental as well as stabilising role in the Indian Money Market. It aims at smoothening liquidity imbalances by developing active Primary and Secondary Markets in all Money Market Institutions. It deals with in Treasury Bills, Commercial Bills, Certificates of deposits, Commercial Paper, Short term deposits, Call and notice Money, Inter Bank participations and Government securities.

1.46 FUNCTIONS AND WORKING OF DFHI :

The discount of Finance House of India was set up by the Reserve Bank of India Jointly with Public Sector banks and All India Financial Institutions to deal in and develop an active Secondary Market for the money market instruments. It Commenced its business operations in April 1988.

At present, the DFHI deals in Treasury Bills, Commercial Bills, Certificate of deposits and Commercial Papers. It also participates in the call and short-notice money markets and the inter-bank term deposit market, both as a borrower and a lender.

From April 1992, the DFHI has commenced dealings in Government of India dated securities. The DFHI has an authorised capital of Rs. 250 crores out of which Rs. 200 crore has been fully paid up.

The main objective of DFHI is to facilitate smoothening of imbalances in the short term money market liquidity by developing an active secondary market for the money market instruments and integrate the various segments of the money market. While bulk of the transactions take place at MUMBAI. The branch offices of DFHI at Ahmedabad, Calcutta, Bangalore, Chennai and New Delhi cater to the needs of the local clientele.

The presence of DFHI has activated the market for treasury bills for which the DFHI is the main market maker and its stands ready to buy and sell treasury bills at its quoted bid and offer discount rates. Besides it provides REPO facility in treasury bills and Government dated securities to Banks for a minimum period of 3 days and a maximum period up to, 14 days at negotiated rate of interest [REPO facility is selling of security under an agreement to purchase back the same at a future date]. The participation in the call money market by DFHI has facilitated Pooling of surplus funds from lenders and channelising a good part of these funds to borrowing Banks in the market. The monetary policy of the State Bank of India provides access to Mutual Funds set up by Private Sector and approved by securities and Exchange Board of India as lenders in the Call/Notice money/ Bills Rediscounting market subject to prior permission to the RBI for operating in the market.

DFHI along with securities Trading Corporation of India was authorised to act as a Primary Dealer in Government securities market with effect from February 29, 1996. Four other primary dealers also became operational in Government Securities Market with effect from June 1, 1996. It is expected that the Primary Dealers System would strengthen the infrastructure in Government dated securities market to make it vibrant, liquid and broad based.

The headquarters of DFHI is located in Mumbai.

1.47 DISCOUNTING SERVICE :

The efficiency of the money markets, indeed the efficiency of the entire monetary system and the ability of money market institutions such as banks to continue as going concerns without countenancing the risk of insolvency or liquidation depends on the existence or availability of institutions, arrangements and services for the best liquidity management. That is the participants in the money market must be in a position to command liquidity in times of need or crisis, and they must be in a position to even out the excesses or deficits in liquidity in different segments of the money market if the latter are to function smoothly. Through efficient liquidity management, the monetary system worked smoothly without experiencing gyrations of the money market rates or without being forced to suffer from monetary losses or liquidation.

Traditionally, in all countries the Central Banks help banks in their liquidity management by providing them discounting and refinancing facilities. One of the most important or Primary functions of the Central Bank in any country has been to supply promptly and in abundance liquidity (funds) to banks on occasions when liquidity shortages threaten economic stability. The Central Bank performs

this function through its discount window or discounting mechanism. Banks borrow funds temporarily at the discount window of the Central Bank; they are permitted to borrow or are given the privilege of doing so from the Central Bank against certain types of eligible paper (collateral) such as the Commercial bill or treasury bill which the Central Bank stands ready to discount (to rediscount, strictly speaking) for the purpose of financial accommodation to banks.

Over the years certain important changes have taken place in the basic discounting mechanism. The term discounting has tended to acquire much broader meaning, scope and purpose than originally intended over time, the Central Bank has come to lend to banks on the basis of any collateral. Most banks borrowing from the Central Bank are now accomplished straight way, i.e., in the from of advances without involving any customerious or without discounting notes of business firms already held by banks. This borrowing takes place on the basis of banks' own Promissory Notes or some Government securities as the collateral. Technically this method of borrowing should be called advance rather than discounting or rediscounting. However, in popular terminology, the term "discounting" has come to describe all borrowings by banks from the Central Bank, regarders of the technical details of how it is accomplished.

Similarly, it is not only in emergencies or for meeting liquidity or financial crises that the Central Bank supplies Financial accommodation to banks. The discounts or advances or refinance from the Central Bank have become a routine (instead of panic-oriented) means of supplying funds to banks for temporary needs or short-term adjustments in the day-to-day course of events also.

The Central Bank, however, is only the ultimate and in a sense an exogenous source of funds to the money markets. In different countries, various institutional arrangements, facilities and practices have evolved which, in addition to the Central Bank, help to provide and smoothen liquidity flows in the money markets. In many countries, banks of various sizes, specialised dealers in bonds, bills and papers and financial institutions discount, rediscount, and refinance money market instruments and smoothen the liquidity flows in the Primary and Secondary markets. In India, institutions such as IDBI, NABARD, SIDBI, EXIM Bank and NHB play an important role in the discount market. In a country like the U.K. a unique, specialised institutional set-up, namely, the discount houses exist to perform this task. A similar set-up is sought to be inititated in India also with the establishment of the DFHI recently. In the following sections we discuss the specialised discounting institutions in the U.K. and India.

1.15 KEY WORDS :

Money Market : Money Market is a large, whole sale market where crores of rupees of low-risk, Unsecured short-term, Zero Coupon debt instruments that are highly liquid are assured and actively traded every day.

Treasury Bill : A Treasury Bill is a particular kind of Financial bill or a Promissory note put out by the Government of a country. Treasury Bills are issued by the behalf of the Central Government.

Commercial Bill : Commercial Bill is a Bill of Exchange which contain an unconditional order by the maker directed a specified person to pay a sum of money to the order or to the bearer of the Bill.

Certificate of Deposit	:	Certificate of Deposit (CD) is a document of title to a time deposit. It is a bearer certificate and is negotiable in the market. Only Banks can issue the CD's.
Commercial Paper	:	Commercial Paper (CP) is a new money market instrument introduced by the RBI in January 1990. These are un-secured promissory notes issued by companies with a networth equivalent to Rs. 4 crores.
Factoring services	:	Bills involving the Bills receivable and Bills payable to companies and Banks are converted into Factorization bills with or without recourse.
Call money	:	Shot-Term Finance is called "CALL MONEY". The day to day surplus funds of the Banks and other institutions are traded in the Call Money Market.
Central Bank	:	The Apex Institution in the Financial System of a country
Scheduled Bank	:	A Bank which has been included in the Schedule II of the RBI Act, 1934.
Note Issue	:	Issue of Paper Currency as a medium of Exchange/ Store of value subject to certain conditions by the Central Bank of the country.
Exchange Control	:	The Regulatory Mechanism adopted by the RBI with regard to all Foreign Exchange Transactions.
Selective Credit Control	:	Credit Control measures pursued by the RBI in respect of certain specific goods and commodities.
General Credit Contorl	:	Controlling mechanism resorted to by the RBI to control flow of credit in general way.
Bank Rate	:	The Standard Rate of Interest at which the RBI is prepared to buy/re-discount Bills of Exchange or Other Commercial Paper eligible for purchase under RBI Act.
Open Market Operations	:	Activities initiated by the RBI by way of purchase/sale of securities in the Market in order to vary the Monetary flow in the Economy.
MORAL SUATION	:	Exhortations by the RBI in the Domain of Extension of credit facilities by the Banking System.
Reserve Requirements	:	Requirements as to maintenance by the Banking Sector of specified balance with RBI as a proportion of demand and Time Liabilities.
District Level Co-operative Banks	:	The middle tier in the Co-operative Banking system at District Level.
Primary Co-operative Credit Society	:	The Primary tier in the Co-operative Banking system at Village Level.
State Level Co-operative Banks	:	The top tier in the Co-operative Banking System at the State Level.
The Banking Regulation Act	:	An enactment Legislated Primarily to protect the Interest of the depositors and regulate the conduct of Banking in

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		the country. The Act was existent earlier under the name of Banking companies Act.
Private Sector Banks	:	Banks where the Major equity of the Banks are held by Private Share holders and where Government does not have holding of Equity Stake.
Public Sector Banks	:	Banks where majority shareholding is held by the Government.
Nationalised Banks	:	Banks which have been wholly taken over by the Government of India under the Provisions of Banking Companies Act 1970/1980.
New Private Sector Banks	:	Private Banks which have been licensed after 1991 and operating in our country. (1) Performance of Public Sector Banks (2) Financial Performance of Nationalised Banks for the years 1999-2000 and 2000-2001. (3) Financial Performance of SBI (4) Financial Performance of Old Private Sector Banks (5) Financial Performance of New Pvt. Banks 6) Foreign Banks (7) NPA are enclosed.
Regional Rural Banks	:	A segment of Rural Banking System formed under Regional Rural Banks Act 1976 to cater to the needs of rural borrowers.
NABARD	:	NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT.
Non Banking Financial Company	:	A Financial Institution defined as per Sec. 451 of the RBI Act 1934.
Regulatory Frame Work	:	Regulation and guidelines issued by the RBI with regard to the operations of NBFC's
Public Deposits	:	Deposits that can be accepted by NBFC from the public inaccordance with the stipulation given by the RBI.
DFHI	:	Discount and Finance House of India

1.16 SELF - ASSESSMENT QUESTIONS :

1) What is a Money Market? How is it different from capital market ?
2) What are the objectives and functions of Money Market?
3) What are the Instruments of Money Market? What are the types of Treasury Bills?
4) Explain the characteristics, advantages of Certificate of Deposits?
5) Explain the characteristics of commercial paper?
6) Describe Major Functions of the Reserve Bank of India
7) Outline the organisation and Management of the Reserve Bank
8) Discuss briefly the Supervisory role of the Reserve Bank
9) Write a brief note on the role of Reserve Bank as a Lender of Last Resort?
10) Explain how the Central Bank is promoting Agricultural and Industrial Finance.

11) Explain the activities of Co-operative Banks.
12) Discuss the strengths and weakness of the Co-operative Banking System in India.
13) Suggest ways and means to strengthen the performance of Co-operative Banks.
14) Describe the activities of Regional Rural Banks.
15) Explain the Strengths and weakness of RBBs.
16) Trace the reasons for growth of Indigeneous Financial Companies?
17) Enumerate the regulatory framework of NBFC's as per the RBI Act?
18) Explain the recent development in respects of NBFC's?
19) Explain the functioning of DFHI
20) Discuss about Discounting Service
21) Trace out the origin and evolution of Commercial Banks?
22) What are the recent policy measures with respect to Licensing of Commercial Banks/Branches announced by the RBI?
23) What are the various dimensions of Regulatory Frame work of the RBI. Describe any two dimensions in detail?
24) Explain the recent changes in Role and Functions of Commercial Banks?

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LESSON - 2

CAPITAL MARKET AND CAPITAL MARKET INSTITUTIONS

OBJECTIVES :

This Lesson aims at equipping the students with complete information about different instruments of Indian Capital Market. The important features of the Capital Market are discussed at length inorder to give the students a fair degree of understanding about the concept of markets.

STRUCTURE :

2.1 Meaning
2.2 Capital Market Instruments
2.3 Capital Market Instruments - Share Capital
2.4 Capital Market Instruments - Equity Capital
2.5 Basic Features
2.6 Types of Preference Shares
2.7 Capital Market Instruments - Debentures
2.8 Types of Debt Instruments
2.9 Introduction
2.10 Investment Banks IDBI, IFCI, ICICI, SIDBI, SFCS, EXIM / IRBI
2.11 Introduction
2.12 Merchant Banking Activities
2.13 Classification of Merchant Banks
2.14 Recent Developments
2.15 Introduction
2.16 Activities of Investment Companies
2.17 Meaning and Functions
2.18 Social Objectives
2.19 Structure of Development Banks of India
2.20 Introduction
2.21 Functions of Stock Exchanges
2.22 History And Development of Stock Exchanges
2.23 Organisation Of Stock Exchanges
2.24 Securities Control (Regulation) Act 1956.
2.25 Powers of The Central Government
2.26 Bye Laws
2.27 Recognition By Government
2.28 Securities Contracts (Regulation) Rules 1957
2.29 Membership Rules Under SCR Act
2.30 National Stock Exchange (NSE)
2.31 Promoters
2.32 Market Segments of NSE
2.33 Salient Features of Trading Systems At NSE
2.34 Listing

2.35 Trading Mechanisms At The NSE
2.36 NSE Membership
2.37 On Line Trading
2.38 Order Routing System (ORS)
2.39 Procedure In On Line Trading
2.40 Advantages of On Line Trading
2.41 Disadvantages of On Line Trading
2.42 Control By SEBI
2.43 Prospects of On Line Trading In India
2.44 Futures And Derivatives
2.45 Introduction
2.46 Mutual Fund in Public Sector - U.T.I. & L.I.C
2.47 Mutual Funds in Private Sector
2.48 Introduction
2.49 Era of Scripless And Paperless Trading
2.50 Depository System - Objectives
2.51 Depository Act 1956
2.52 Features of Depository System
2.53 Dematerialisation of Shares
2.54 Procedure of Dematerialisation
2.55 Dematerialisation
2.56 Limitations of Dematerialisation
2.57 Stock Lending
2.58 Approved Intermediaries
2.59 National Securities Depository Ltd.,
2.59.1 Objectives
2.60 Services of NSDL
2.61 Central Depository and Securities (India) Limited (CDSIL)
2.62 Multiple Depository System
2.63 Key Words
2.64 Self - Assessment Questions
2.65 Further Readings

2.1 MEANING :

Financial Market consisting of Capital Market and Money Market constitute one of the major elements of a Corporate Firm's operating environment. These firms use Capital Market in raising long term funds to take up their capital budgeting proposals. Capital market refers to all facilities and institutional arrangements for borrowing and lending of term funds. Capital market does not deal in capital goods, but is concerned with the raising of money capital.

2.1.1 INDIAN CAPITAL MARKET BEFORE INDEPENDENCE :

The capital market in India was not properly developed before Independence. The following are the reasons for this.

1) Agriculture was the main occupation but there was very little of organised long term lending to this sector.

2) There was little growth of the securities market because most of the English Enterprises in India looked to the London Market rather than to the Indian Capital Market.
3) The total number of companies was small and the number of securities traded on stock exchanges was still smaller.
4) A large Part of Capital Market was consisted of the guilt-edged market for Government securities.
5) Individual investors were very few and limited to the affluent classes in the urban and rural areas.
6) The Government had placed many restrictions on the institutional savers, such as Banks and Insurance companies which were forced to prefer Government securities.
7) The Managing agency system performed to some extent the functions of promotion of issues and under - writing of new issues.
8) The specialised Financial Intermediaries have not yet been developed.

2.1.2 INDIAN CAPITAL MARKET AFTER INDEPENDENCE :

Since Independence particularly after 1951, the Capital Market in India has been growing significantly. Many factors have contributed to this growth.

1) STEADY GROWTH OF SAVING AND INVESTMENT :

The volume of Saving and Investment in the country has been increasing steadily which is a clear indicator of the growth of Capital Market. The following factors led to the improvement in Saving and Investment.

a) The Government provided all types of encouragement and tax relief to promote Savings in the country.
b) Many steps have been taken to promote the interests of the investors.
c) The growth of Joint-stock companies or Corporate enterprises is an important indicator of the growth of Capital Market.
d) Another indicator of the growth of Capital Market is the growth of public borrowing for investment purposes.
e) The growth of Life Insurance also led to the promotions of Savings and supply of funds in the Capital Market.
f) Increase in Provident Fund collections is another factor promoting the Capital Market in the country.
g) Growth of Banks and Non-bank Financial Intermediaries encouraged mobilisation and channelisation of Country's Savings.

2) ROLE OF COMMERCIAL BANKS :

Commercial Banks are important constituents of the Capital Market, but their operations in this market are mainly limited to the purchase and sale of Government securities.

3) GROWTH OF SPECIAL FINANCIAL INSTITUTIONS :

Soon after Independence the Government of India started a series of Financial Institutions to assist the Private sector industries in the matter of finance. The Industrial Finance Corporation of

India (IFCI) 1948 was the first such Institution. It was followed by State Finance Corporations (SFCS) set up by State Governments, to provide financial assistance to small and medium industrial units. The Industrial credit and Investment Corporation of India (ICICI 1956), the Industrial Development Bank of India (IDBI 1964) and the Unit Trust of India (UTI) 1964. The Life Insurance Corporation (LIC) was set up in 1956.

4) NEW INSTITUTIONS :

Recently, many new Financial Intermediaries have emerged in Indian Capital Market which have not only accelerated its growth, but also improved its efficiency and competitiveness both domestically and internationally. Important institutions are :-

1) Merchant Banking :

This was originally started by the Commercial Banks as Merchant Banking divisions. Then they developed Merchant Banking subsidiaries.

2) Leasing And Hire Purchase Companies :

A number of companies, Banks and Non-Banking Financial Institutions provide Lease and Hire purchase Finance. Leasing is a method of financing through which firms can acquire the economic use of assets for a specified period without owning them. Under hire purchase finance system, loans are provided to purchase the goods on Instalment basis.

3) Mutual Funds :

Recently many Commercial Banks and other Financial Institutions have set up Mutual Funds on tax-exempt basis for attracting and encouraging investors.

4) Venture Capital :

Venture Capital Financing is a quite recent entrant in the Capital Market. It has great significance in assisting Technocrat Entrepreneurs who have technical competence and expertise but lack venture capital.

5) Other Institutions :

Besides these, some other Institutions have been set up in the country to cater to the needs of Commerce and Trade in the areas of Venture Capital, Lease Finance, Credit rating etc., Important among them are -

a) Risk Capital and Technology Corporation Ltd., (RCTC).
b) Technology Development and Information Company of India (TDICI).
c) Infrastructure Leasing and Financial Services Ltd (ILFS).
d) Credit Rating Information Services of India Ltd., (CRISIL).
e) Stock Holding Corporation of India Ltd (SHCIL).
f) Securities Exchange Board of India (SEBI)

2.1.3 STRUCTURE OF INDIAN CAPITAL MARKET :

A Brief Summary of the structure of Indian Capital Market is illustrated below.

CAPITAL MARKET IN INDIA

1) Capital market in India can be divided into two sectors (a) Organised (b) Un-organised
2) The Un-organised sector mainly includes Indigenous bankers, Money lenders, Chit funds, Nidhis and other similar financial institutions, investment companies, finance companies, hire purchase companies, company deposits etc. The role of Un-organised sector is not of much importance.
3) Organised sector comprises of (a) Stock or securities market and (b) Term Lending Institutions such as RBI, Banks and Non-Bank Financial Intermediaries (VIZ, IDBI, ICICI, LIC, GIC, UTI etc.).
4) Stock Market comprise several distinct markets in securities. The most important classification is between Gilt-edged market and Industrial securities market.
5) The Guilt-edged market refers to the market for Government and Semi-Government securities, backed by the Reserve Bank of India.
6) The Industrial securities market refers to the market for equities and debentures of old and new companies. The market is affected by the factors like tax measures, corporate news of production, political conditions etc.
7) Industrial securities market has been further divided into a) Primary (New issues) Market and Secondary (Old issues) Market.
8) The Primary market refers to raising of New Capital in the form of Shares and Debentures. While Secondary Market deals with securities already issued by the companies. Both the Markets are important but the New Issues Market is much more important from the point of view of Economic growth.
9) Stock exchange is an organisation where orderly buying and selling of listed (or approved) existing securities is done.

2.1.4 CAPITAL MARKET FUNCTIONS :

The Capital Market works as a mechanism to facilitate the transfer of funds from the Investors to the borrowers. This transfer of funds will be optimum if the capital market is efficient. The Capital Market in India is one of the emerging and promising capital markets in the world. After 1990, it has witnessed vibrant growth. Several new features have come up since the securities and Exchange Board of India was established in 1982. The emergence of screen based Trading, Depositories credit rating system, Investor’s protection centres etc., are some new concepts on the horizon of the Indian Capital Market.

2.2 CAPITAL MARKET INSTRUMENTS :

As the Business firms viz., Corporate partnership firms, Sole owner firms etc., obtain funds from various sources. These sources may be broadly classified into capital (both equity and preference) and debts (including bonds, debentures, long term borrowings and other debt Instruments). Whenever a firm needs funds to buy assets or implement any other investment decision, it must choose a blend of funds from equity and debt. The debt may be defined as any Financing Instrument that has a contractual claim on the cash flows of the firm (not as a function of operational performance), creates tax deductible expenses, has a fixed lite and has a priority in operating profits as well as in liquidation. On the other hand, the equity may be defined as a Financing Instrument that

has a residual claim on the cash flows, does not create a tax advantage for its payments, has an infinite life, does not have priority in liquidation and provides Management control to the holder.

Debt and equity are differentiated mainly on the basis of the cash flows of each type of financing.

2.3 CAPITAL MARKET INSTRUMENTS - SHARE CAPITAL :

The different sources and instruments of long term finance are explained below. The promotor of any company is generally concerned with what the potential investor in the company wants in terms of rights and privilages by subscribing to the shares of the company. The composition of share capital of any company is stated in the basic character i.e., Memorandum of Association and the company is legally authorised to issue different types of share capital only within this frame work. The share capital of company consists of two types of shares

1) Equity or common shares and
2) Preference Shares.

2.4 CAPITAL MARKET INSTRUMENTS - EQUITY SHARE CAPITAL :

The primary source of finance to any company is equity share capital. Equity share certificates are legal documents that evidence ownership (or equity in a company that is organised as a corporation. They are also marketable financial Instruments. Though sole proprietorships and partnerships are equally popular forms of business organisation only corporations can issue common stock i.e. Equity share capital.

Equity share capital is distinctly different from all other sources of funds. The existance of Equity shares in the capital structure of a company is an absolute prerequisite to the creation of a company and an essential ingredient to its future growth.

2.4.1 BASIC FEATURES :

Some of the basic features of Equity shares are as follows :

A) VOTING RIGHT :

Shareholders of Equity capital are owners of the firm. The money invested by them does not mature at some feature date. They represent permanent capital which is expected to remain with the company indefinitely. Shareholders of Equity capital receive voting rights to permit them to control the matters of the organisation.

B) RIGHT TO SELL OR TRANSFER EQUITY SHARES :

Equity shareholders have the right to sell or transfer their holding to other persons. No permission is required from the Management or other shareholder for such sale. A shareholder may directly sell his holding by merely signing an agreement. If the share is listed on a Stock exchange, the shareholder may also sell his holding on the Stock exchange and the buyer of the shares will have to get these shares transferred in his name in the records of the company. The new shareholder will then be entitled to receive dividends and other rights and privileges attached with these shares.

C) RESIDUAL CLAIM ON ASSETS :

The claims of Equity shareholders on the assets of the company are secondary to the creditors and are relevant only when the firm is being liquidated. Sections 529, 529A and 530 of the Companies

Act 1956 provide that in case of liquidation, the assets are distributed first to the employees then to the preferential creditors, then to the secured creditors then to the general unsecured creditors, then to the preference shareholders and finally to the equity shareholders. The position of the equity shareholders with regard to firm's assets is therefore residual. Other claimants are paid before the equity shareholders receive anything.

D) PRE-EMPTIVE RIGHT :

The right of the shareholders to subscribe to issue of additional shares before these are offered to public is known as Pre-emptive right. It refers to the right of the shareholders to maintain their proportion of the ownership of the company by subscribing to new shares being issued.

E) RIGHT TO RECEIVE THE ANNUAL REPORT :

Sec. 219 of the Companies Act 1956 requires that the annual report of the company (consisting of the Balance Sheet, Income Statement, Directors Report, Auditors Report, Cashflow Statements and other statements and annexures) should be sent hot less than 21 days before the General meeting to every shareholder of the company. The listing agreement and the SEBI guidelines also require that the company should make quarterly and half yearly results of operations public. All these rights make the Investor (equity shareholder as well as others) aware of the affairs and operations of the company.

CAPITAL MARKET INSTRUMENTS :

Preference Share Capital is a type of security through which a company obtains funds and as the name itself implies it enjoys certain types of preferential treatment which are not accorded to the Company's Equity shares. Preference shares occupy a position similar to that of a limited partner in general preference in the distribution of assets in the event of liquidation of the business with respect to distribution of assets in the event of liquidation of the business with respect to distribution of earnings. Sec. 85 of the Companies Act 1956 defines preference shares as those which have the following two characteristics.

1) These shares have a Preferential right to be paid at a fixed rate and

2) These shares have Preferential right to the return of capital in case of liquidation. Both these preferences are available to Preference shareholders as against the equity shareholders. As a source of financing, the preference shares are given preference in income distribution as well as in distribution of assets in the case of liquidation of the company.

2.5 BASIC FEATURES :

A part from the above mentioned features there are some more points which distinguish the Preference shares from Equity shares that are mentioned below :-

1) Preference shares on one hand have a prior claim relative to Equity shareholders in the income and in the firm's assets, but on the otherhand, are subordinate to all debts with respect to earnings and assets.
2) Preference shares are a part of ownership of the company.
3) No additional or mortgage is required, as it is not a debt.

4) Dividends at a fixed rate are payable on preference shares and so the company has a fixed financial commitment. Further, that unlike debt interest which is a charge against profit, the preference dividend is an appropriation of profit and hence no compulsory payment.

5) Preference share is hybrid kind of security having some features of debt and some of equity. Preference shareholders get a fixed dividend rate and this fixed rate plus their prior claims to income and assets make them resemble debenture holders. Even, the preference share capital represents an ownership interest and not a liability of the company.

6) Failure to meet commitment of preference dividend is not a ground for liquidation. This commitment includes that the preference shareholders have the right to receive dividends in priority over the Equity shareholders. In fast, it is this Preference which distinguishes Preference shares from Equity shares.

7) A dividend need not necessarily be paid on either type of shares. However, if the Directors want to pay equity dividend then the full dividend, due on the preference shares must be paid.

8) Even if earnings are sufficient to pay the preference dividend and even if enough cash is available to make payment, the Director's are not obliged to declare the dividend payable nor can the preference shareholders take legal action to obtain their unpaid dividends. The only commitment made by the company is that preference dividends will be paid in the amounts agreed upon before any dividends are paid on equity shares. This commitment itself is generally sufficient to cause Management to treat preference dividends as if they were a Legal Periodic obligation of the company. Theoretically it is also possible that the company may pay only preference dividend but no dividend to equity shareholders.

9) The position of preference shareholders as the ownership holder of the company is limited and restricted against the Equity Shareholders.

10) Section 87 of the Companies Act, 1956 provides that the preference shareholders can exercise the right to vote only on resolutions placed before the company which directly affect the rights attached to preference shares. However, they can vote on every resolution placed before the company, if the dividend on preference shares has remained unpaid (1) In case of cumulative preference shares for an aggregate period of not less than 2 years and (2) in case of non-cumulative preference shares for a period not less than 2 years (immediately preceeding) or not less than 3 years comprised in past 5 years. However as against the equity shares which are not to be redeemed during the life time of the company the preference shares must be redeemed within a period of 20 years from the date of issue (Sec. 80 A of the Companies Act, 1956)

11) Unless otherwise stated in terms of issue, the preference shares are cumulative and the dividends on these shares, if could not be paid in a particular year or years because of no or insufficient profits, get accumulated and are paid in future whenever the company wants to pay equity dividend.

12) These shares have limited voting right as described in Sec. 87. So, the voice of the preference shareholders in the Management of the company is quite limited.

13) Most of the preference shares have a par value when it does, the cash dividend to which the shareholders are entitled is usually stated as a percentage of the par value. However, the amount of the preference share holders cash dividends could be a specified amount even if

there were no par value. As with common stock, it seems that preferred shares that have a par value has no real advantage over preferred, that has no par value.

2.6. TYPES OF PREFERENCE SHARES :

Broadly there are only two types of Preference shares 1) Cumulative 2) Non-cumulative Preference Shares.

1) Cumulative preference shares are those holders of which are entitled to a dividend whether or not the firm earns the profit. If the company misses any part of a preferred Dividend, it is not lost but must be made up in a latter year before any cash dividends can be paid to the common share holders.

2) Holders of Non-Cumulative Preference shares are entitled to cash dividends only if they are earned. If the company omits a cash dividend payment that dividend is lost to the preferred shareholders forever. To protect preferred investors, the company cannot legally pay dividends to its common stock during some dividend period if it has missed a preferred dividend during that period.

2.7 CAPITAL MARKET INSTRUMENTS - DEBENTURES :

According to Companies Act 1956 “Debenture includes debenture stock, bonds and any other securities of company, whether constituting a charge on the assets of the company or not”. Debentures are generally issued by the private sector companies as a long term Promissory note for raising loan capital. The company promises to pay interest and principal as stipulated. Bond is an alternative form of Debenture in India. Public sector companies and Financial Institutions issue bonds.

Characteristic Features of Debentures :

1) A debenture holder is entitled to a pre-determined and agreed interest amount and redemption of principal amount.
2) The Interest expense, which accrues to the debenture holders is an allowable charge against profits under Indian Income Tax Act 1961.
3) The payments on the debentures are contractual.
4) The payment of interest is tax deductable from the point of view of the paying firm.
5) The debenture has a fixed life.
6) A Debenture may have a market value less than equal to or more than equal to more than the face value depending upon the required rate of return and the coupon rate.

If the required rate of return is 16% and the coupon rate is 10% then the debenture is likely to have a market value less than the face value and vice-a-versa. In the event, the coupon rate and the required rate of return are equal, then the debentures will be traded as its face value.

There is no provision in the Companies Act in case of any default in respect of debentures either in respect of payment of Interest and repayment of principal. However, in respect of non-receipt or delay in receipt of debenture certificate, the Investor can proceed against the company under Sec. 113 of the Act as in the case of equity or preference share certificates.

The rate of Interest is fixed at the time of issue itself which is known as contractual or coupon rate of Interest. Interest is paid as a percentage of the par value of the debenture and may be paid annually, semi-annually or quarterly. The company has the legal binding to pay Interest rate.

As stated the redemption date would be specified in the issue itself. The maturity period may range from 5 years to 10 years in India. They may be redeemed in Installments. Redemption is done through a creation of sinking fund by the company. A Trustee incharge of the fund buys the debentures either from the market or owners. Creation of the sinking fund eliminates the risk of facing financial difficulty at the time of redemption because redemption requires huge amount. Buy back provision help the company to redeem the debentures at a special price before the Maturity date.

Indenture is a Trust deed between the company issuing debenture and the debenture trustee who represents the debenture holders. The Trustee takes the responsibility of protecting the interest of the debenture holders and ensures that the company fulfills the contractual obligations. Financial Institutions, Banks, Insurance companies or Firm attornies act as Trustees to the Investors. In the Indenture the terms of the agreement, description of debentures, rights of debenture holders, rights of the issuing company and the responsibilities of the company.

2.8 TYPES OF DEBT INSTRUMENTS :

Debentures are classified on the basis of the security and convertibility.

1) SECURED OR UN SECURED DEBENTURES :

A secured debenture is secured by a Lien on the company's specific assets. In the case of default the Trustee can take hold of the specific asset on behalf of the debenture holders. In the Indian Market secured debentures have a charge on the present and future immovable assets of the company. When the debentures are not protected by any security that are known as Un-secured or Nacked Debentures. In the American capital market Debenture means Un-secured Bonds while the Bonds could be secured or un-secured. Un secured debentures find it difficult to attract investors because of the risk involved in them. Generally, debentures are rated by credit rating agencies.

2) FULLY CONVERTABLE DEBENTURE :

This type of Debenture is converted into equity shares of the company on the expiry of specific period. The conversion is carried out according to the guide lines issued by SEBI. The F.C.D carries lower interest rate than other types of debentures because of the attractive feature of convertibility into equity shares.

3) PARTLY CONVERTABLE DEBENTURES :

This Debenture consists of two parts namely convertable and non-convertable. The convertable portion can be converted into shares after a specified period. Here, the Investor has the advantage of convertable and non-convertable debentures blended into one debenture.

4) NON-CONVERTABLE DEBENTURE :

Non-convertable Debentures do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of the specified period.

5) MULTI-OPTION CONVERTABLE DEBENTURES :

Some famous companies like Reliance Petroleum Ltd., D.L.F Cements Ltd., etc., have issued Multi-option convertable debentures where the debenture holder is given different options about the conversion, its made time etc. The Debentures of Reliance Petroleum, Ltd., were named as Triple Option Convertable Debentures (TOCD).

6) ZERO INTEREST FULLY CONVERTABLE DEBENTURES (ZFCD) :

In this type, the debenture is compulsorily fully convertable into equity shares at the expiry of a given period (Not exceeding 3years) from the date of issue. For the intervening period, no interest is payable by the company to the debenture holder. The return to debenture holders is available in the form of difference between the issue price of the ZFCD and the market price of the converted shares. Eventhough, the ZFCD are ultimately to be converted into equity share capital yet if the period of conversion is after 18 months from the date of issue, then as per the SEBI guide-lines the issue of ZFCD must be credit rated by an approved credit rating agency. In case of ZFCD, the debenture holders are not given any option and are compulsorily converted into Equity share capital. Mahindra and Mahindra Ltd., and Indian Rayon Industries Limited have issued in this manner.

7) SECURED PREMIUM NOTES (SPN) :

During August 1992, TISCO LTD issued a special Debt instrument called SPN, having a face value of Rs. 300. No Interest was payable on this and it was to be redeemed in four equal instalments of Rs. 150 each (Totalling Rs. 600) at the end of 4 th to 7 th year. Out of each repayment of Rs. 150, Rs. 75/- was to be considered as repayment of the principal and Rs. 75/- was to be considered as capital gain. There was a warrant attached with the SPN which entitled every SPN holder to get one Equity share from the company at a price of Rs. 100/-.

8) ZERO COUPON BONDS :

These Bonds sell at a discount and the face value is repaid at maturity. The origin of this type of Bond can be traced in the U.S. security market. The high value of the U.S. Government security prevented the Investors from investing their money in the Government security. Big Brokerage companies like Merril Lynch, Pierce and others purchased the Govt. securities in large quantum and resold them in smaller denomination at a discount rate. The difference between the purchase cost and the face value of the bond is the gain for the Investor. Since the Investor does not receive any Interest on the bond. The conversion price is suitably arranged to protect the interest loss to the Investor. The discounted value is calculated using the Formula :

$$\text{Present Value} : \frac{\text{Face value of the Bond}}{(1+R)^n}$$

R = Interest Rate and n = Number of years

For example a Zero coupon bond that matures in 20 years time with the face value of Rs. 50,000 would be sold at Rs. 5185 to give a return of 12 percent per annum. The merit of this Bond is that the company does not have the burden of servicing the debt during the execution period of the project. The repayment could be adjusted to fall after the completion of the project. The repayment could be adjusted to fall after the completion of the project.

9) DEEP DISCOUNT BONDS :

This is another form of Zero coupon Bond. The Bonds are sold at large discount on their nominal value : Interest is not paid for them and they mature at par value. The difference between the maturity value and the issue price serves as an interest return. The deep discount Bonds maturity period may range from 3 years to 25 years or more. IDBI was the first to issue deep discount bonds

in India in 1992 with varying maturity options. ICICI also issued deep discount bonds with four optional maturity periods in 1997. Early redemption option is provided at the end of the 6th, 12th and 18th year.

10) CAPITAL INDEXED BONDS :

In this type, the principal amount of the Bond is adjusted for inflation for every year. For example, an Investment of Rs. 1000/- in the inflation indexed bonds earn the investor a semi annual interest income for the five years period. The reselling of the principal amount is done semi annually based on the WPI movements. The principal amount of the Bond is adjusted for inflation for each of the years. On the inflation adjusted principal the coupon rate of 6 percent is worked.

The benefit of the Bond is that it gives the Investor an increase in return by taking Inflation into account. The investor enjoys the benefit of a return on his principal, which is equal to the average inflation between the issue (purchase) and maturity period of the Instrument. To avail the benefit of inflated principal, the Investor needs to hold the Instrument for the entire 5 years period.

INVESTMENT BANKS

Objective :

After going through this lesson you should be able to understand the components of Investment Banking System in our country and also the role played by these banks in the process of Economic Development.

Structure :

2.9 Introduction

2.10 Investment Banks IDBI, IFCI, ICICI, SIDBI, SFCS, EXIM / IRBI

2.9 INTRODUCTION :

Investment Banks are also known as Industrial Banks or Development Banks, mainly to meet the medium-term and long term financial needs of the Industries. Such long term needs cannot be met by Commercial Banks which generally deal with short term lending. The main functions of the Industrial Banks or Investment Banks are (1) They accept long term deposits (2) They grant term loans to the Industrialists to enable them to purchase land, construct factory building, purchase heavy machinery etc., (3) They help selling or even underwrite the debentures and shares of Industrial firms (4) They can also provide information regarding the general economic position of the economy.

There is no precise definition of a Development or Investment Bank. William Diamond and Shirley Bosky consider Industrial Finance and Investment Corporations as “Investment Banks”.

Investment Bank is essentially a multi-purpose financial Institution with a broad development outlook. An Investment bank may thus be defined as a Financial Institution concerned with providing all types of financial assistance (medium as well as long term) to business units in the form of loans. Under writing Investment and guarantee operations and promotional activities, economic development in general and industrial development in particular.

In short an investment bank is a development oriented bank.

History of investment banking in India can be traced to the establishment of the Industrial Finance Corporation of India (IFCI) in 1948.

As on date there are more than 60 Industrial investment institutions at both Central and State levels. The growth of Investment Banking Institutions can be studied from different phases as under.

1) Institutionalisation (1948-55)
2) Expansion (1955-64)
3) Consolidation and Innovation (1964-76)
4) Stability and Growth (1976-84)
5) Diversification and Change (1984-92)
6) Reorientation (1992 On wards)

2.10 PROMINENT INVESTMENT BANKS AND THEIR SERVICES ARE AS FOLLOWS:

1) The Industrial Finance Corporation of India (IFCI) Ltd is the First Investment Finance Institution set up in 1948 for providing medium and long term credit. IFCI became a company effective from 1st July 1993. The Registered Office of IFCI is in Delhi.

The services offered by IFCI are as under

1) Project Finance
2) Financial Services
3) Promotional Services

Assistance is available for units in corporate and Co-operative sectors for new units expansion/ diversification by way of Rupee and Foreign currency loans. Underwriting and direct subscription to shares/debentures guarantee for deferred payments and Foreign currency loans.

2) FINANCIAL SERVICES :

Under this category IFCI has been extending merchant banking services, equipment leasing, equipment credit, Instalment credit, suppliers/buyers credit and finance to leasing and hire purchase companies.

3) PROMOTIONAL SERVICES :

Under this Banner IFCI has been extending the following kind of services. 1) Technical Consultancy 2) Risk and Venture Capital 3) Entreprenuership Development 4) Management Development 5) Development of Rural and Urban poor through voluntary organizations (Development of Bio-Technology/ Technology entreprenuership parks and research.

Subsidy support is provided to village and small industries. IFCI has promoted Institutional Infrastructure through specialised institutions such as Technical Consultancy Organizations (TCOS) in various states, Management Development Institute (MDI), Risk Capital and Technology Finance Corporation Ltd., (RCFTC) Tourism Finance Corporation of India (TFCI) Rashtriya Gramin Vikas Nidhi (RGVN) Investment Information and Credit Rating Agency (ICRA) Industrial Labour Development (ILD) Tourism Advisory Financial Services Corporation of India Ltd., (TAFSCIL). IFCI is also a co-

promotor of stock holding Corporation of India Ltd. Entrepreneurship Development Institute of India, OTC Exchange of India Ltd., National Stock Exchange Ltd., and Bio-Tech consortium India Ltd.

2) INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI) :

The Industrial Credit and Investment Corporation of India, a leading financial institution was established in 1955 to finance industrial development.

The ICICI over the years was instrumental in promoting number of other institutions such as Housing Development Finance Company (HDFC), CRISIL (A credit rating company) ICICI securities and Finance Company Ltd., ICICI Investors Services Ltd., ICICI Mutual Fund and also the ICICI Banking Corporation Ltd., (ICICI Bank).

Traditionally the corporation's core business has been provision of project finance to Industrial enterprizes in the form of Rupee and Foreign currency loans, underwriting and direct subscription to issuances of shares and debentures and guarantees to suppliers of equipment and foreign lenders such assistance is provided to finance cost of the establishment, modernisation or expansion of manufacturing and processing facilities. The ICICI has diversified its activities into different forms of asset financing such as leasing asset credit and deferred credit as well as finance for non-project activities which are typically of short term nature. It has also a significant involvement in the financial advisory and consultancy business through its advisory services division and business consultancy division. In the last few years it has emerged as a premier agency for providing grants for development and commercialization of technologies through its Technology Finance Division. Together with its subsidiaries and group companies, ICICI has a major presence in almost all areas of Financial Services Industry which include long term lending Investment banking, Commercial Banking, Mutual Funds, Venture Capital, Consultancy and Advisory Services and Custodial Services.

3. INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI) :

Established on July 1, 1964 as a wholly owned subsidiary of the RBI. Subsequently in 1976 it was delinked with the RBI and made the Principal Financial Institution for the Industrial Sector and its ownership was transferred to the Govt. of India. The Head Office of IDBI is located in Mumbai.

The functions and working of IDBI are governed by the Industrial Development of India Act 1964. In 1976 the ownership of IDBI was transfering to the Govt. of India and was entrusted with the additional responsibility of acting as Principal Financial Institution for co-ordinating the activities of institutions engaged in the financing, promotion and development of industry. In 1982, the IDBI transferred its International Financial Division which was providing export finance to industry to export bank of India, which was established as a wholly owned corporation of the Govt.of India under Export-Import Bank of India Act 1982. In 1990, IDBI's Portfolio relating to small scale Industrial sector was transferred to the Small Industries Development Bank of India which was established as a wholly owned Corporation of the Government of India under Export Import Bank of India Act 1982.

IDBI provides finance for the establishment of New Industrial Projects as well as for expansion, diversification, modernisation of existing Industrial enterprises. IDBI has made efforts to respond to the financial needs of the industry by constantly expanding its range of products and services. Under Direct Finance IDBI has been offering facilities for (1) Project Finance (2) Equipment Finance and

Asset Credit (3) Equipment Leasing (4) Direct discounting of Bills (5) Underwriting and direct subscription (6) Energy conservation (7) Venture capital (8) Working capital. Under the Indirect Finance (1) Refinancing of Industrial Loans (2) Bills re-discounting (3) Investment in shares and bonds of other Financial Institutions (4) Lines of Credit to Institutions are the services extended by IDBI. In the category of Financial services the following step services are being offered : (1) Merchant Banking (2) Forex services (3) Debenture Trusteeship. It is how the IDBI is contributing a lot for the Economic Development.

4) SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI) :

This was established in 1980 under the small Industries Bank of India Act 1989, as a wholly owned subsidiary of IDBI. The Head Office of SIDBI is located at Lucknow. The main objectives and functions are (1) to serve as the Principal Financial Institution for promotion, financing and development of small scale Industries and (2) to co-ordinate the functions of the institutions engaged in promoting, financing or developing small scale industries. The main functions of the SIDBI are to providing term loans to SSI ancillary units as also to specialised marketing and infrastructure development agencies and hire purchase companies. Foreign currency loans are provided to export oriented small units to import equipment. Resources support is provided to State Small Industries Development Corporation, factoring companies as also lines of credit to merchant banks for supporting equity issues of SSI Units Over The Counter Exchange of India (OTCEI). Direct equity Investment is made in well run SSI Units for expansion/diversification, Exports and introduction of Higher Technology. Refinance is granted to banks and state level financial institutions extending credit to SSI sector/small road transport operators under the single window scheme. Other activities includes Bill Financing, provision of equity type soft loans for women, ex-servicemen, first generation entrepreneurs and venture capital support to entrepreneurs using innovative indigenous technology. SIDBI also provides support services to SSI in such areas as technology upgradation/modernisation, quality promotion including ISO - 9000 certification, entrepreneurship development, Export Promotion and marketing support to voluntary organizations engaged in assisting socially and Economically disadvantaged sections, savings/credit groups of women in rural areas.

5) STATE FINANCIAL CORPORATIONS (SFCS) :

Under the State Financial Corporation Act 1951, various State Governments have established SFC's for meeting the term credit needs of small and medium scale industries. In Tamilnadu, the TAMILNADU INDUSTRIAL INVESTMENT CORPORATION Ltd., set up in 1949, as a joint stock company functions on the lines of SFC's. The assistance given by SFC's to Industrial Units is mainly through loans, underwriting of Shares, Bonds and Debentures and guaranteeing of deferred payments for capital goods purchases. Under the SFC Act, the SFC's can provide assistance to Industrial Units whose paid up capital and reserves do not exceed Rs. 10 crore. There is a statutory provision under RBI Act, 1934 for the grant of short-term loans and advances for periods not exceeding 90 days and also for granting loans for a maximum period of 18 months against Central and State Government securities to SFC's.

A Committee under the chairmanship of S.H. Khan, Chairman IDBI reviewed the working of SFCs and recommended wide ranging amendments to the SFC's Act and restructuring and granting of autonomy to SFC Boards.

6) STATE INDUSTRIAL DEVELOPMENT CORPORATIONS (SIDC'S) :

The State Industrial Development Corporations (SIDC's) were established under the companies Act 1956, in the sixties and early seventies as wholly owned State Government undertakings for promotion and development and provide impetus to Investment in their respective states. The SIDC's provide financial assistance in the form of term loans, underwriting/direct subscription to shares and debentures as also guarantees. They undertake a range of promotional activities such as preparation of feasibility reports, conducting industrial potential surveys and entrepreneurship development programmes and developing industrial areas/estates.

The SIDC's are involved in setting up medium and large industrial projects in the joint sector in collaboration with Private Entrepreneurs or as wholly owned subsidiaries. The SIDC's act as agents for providing Tax benifits under the State Governments Package System incentives. SIDC's act as agents of IDBI/SIDBI for the seed capital scheme. Some SIDC's also after a package of developmental services which include Technical guidance, assistance in plant location and co-ordination with other Agencies. Intune with changing Economic Scenerio and Financial Sector Environment, several SIDC's are making efforts to undertake the Business of Equipment Leasing; Merchant Banking and Mutual Funds. There are 26 SIDC's in the country. 11 SIDC's also function as SFC's to provide assistance to small scale sector and to act as Promotional Agencies. This is how SIDC's are contributing for Industrial Development in the country.

7) EXPORT IMPORT BANK OF INDIA (EXIM BANK) :

The EXIM Bank was established on 1st January 1982 under the Export-Import Bank of India Act 1981. Promotion of India's International Trade is the major goal of Exim Bank. The Bank's charter sets out the objectives namely to finance exporters and importers, to function as the Principal Financial Institution for co-ordinating the work of Institutions engaged in Financing Export to Import, to finance Export oriented Institutions and to finance Export oriented Industries and to finance promotional activities necessary for International Trade.

The Exim bank is wholly owned by the Government of India. The Bank has the authorised capital of Rs. 500 crores. Exim Bank has a variety of programmes to meet the needs of
1) INDIAN EXPORTERS 2) COMMERCIAL BANKS AND 3) OVERSEAS ENTITIES. The schemes for exporters include 1) Pre-shipment Credit 2) Suppliers Credit 3) Overseas Investment Finance 4) Export product development loans 5) Loans for Export Marketing 6) Production Equipment Finance 7) Finance for consultancy & Technology Services 8) Finance for deemed Exports 9) Financing Rupee expenditure for project export contracts 10) Project preparatory services overseas. 11) Business Advisory and Technical assitance services overseas.

To the Commercial Banks EXIM Bank offers : 1) Export Bills rediscounting facility 2) Refinance of suppliers credit 3) Refinance of term loans to Export oriented Units and Bank import Finance 4) Participation in guarantees issued by Commercial Banks on behalf of Indian Project Exporters. Foreign Governments and Agencies are offered buyer's credit and Lines of credit. EXIM bank provides services through a network of offices in India and abroad at the following places. 1) MUMBAI 2) CHENNAI 3) KOLKATA 4) BANGALORE 5) AHMEDABAD 6) NEW DELHI 7) WASHINGTON 8) SINGAPORE 9) BUDAPEST 10) ROME AND JOHANESSBERG. The Head Quarters of EXIM Bank is located in MUMBAI.

8) THE INDUSTRIAL RECONSTRUCTION BANK OF INDIA LTD :

This was established in March 1985 as a statutory corporation under IRBI Act in Calcutta. Zonal Offices were set up at Mumbai, Kolkata, Delhi and Chennai and Branch Offices at Ahmedabad, Bangalore, Bhopal, Guwahati, Hyderabad and Lucknow. Besides providing term loans to sick units, IRBI extends various financial and developmental banking services including financing of green field projects. Specific schemes like Equipment Finance and Hire purchase to Industrial companies for acquiring equipment were introduced by IRBI. The IRBI took several steps to re-orient its business strategy in response to changing conditions/competition in financial sector. Accordingly, IRBI has introduced schemes such as short term secured/unsecured loans, short term loans for working capital. Asset credit scheme, issue management activities including pre-issue appraisal and loan syndication and underwriting assistance. In 1997, the Bank has been renamed as INDUSTRIAL INVESTMENT BANK OF INDIA to indicate its greater role as an Investment bank also.

MERCHANT BANKS

OBJECTIVE :

After going through this lesson you should be able to understand about Merchant Banking and its activities and Recent Developments.

STRUCTURE :

2.11 Introduction
2.12 Merchant Banking Activities
2.13 Classification of Merchant Banks
2.14 Recent Developments

2.11 INTRODUCTION :

The beginning of Merchant banking in India on a professionalised basis was in 1967, when the Grindlays Bank established it's Merchant Banking Division subsequently, the banking commission (1972) made certain recommendations which contributed to the envelopment of Merchant Banking in India. Many Public Sector Banks and Financial Institutions including SBI, Bank of India, Bank of Baroda, ICICI started Merchant Banking Divisions. The range of activities of merchant bankers were considerably enlarged during the seventies and eighties.

The total number of Merchant Banks increased from 36 in 1991-1992 to over 500 in 1995-1996.

Merchant Banking is an omnibus term covering a variety of services offered to the corporate customers for establishing new companies and commissioning projects undertaking modernisation / expansion / diversification of existing units, amlgamation and merger of companies etc., in brief any services rendered for any related job right from the incorporation of the company till the implementation of the project can be undertaken under the Merchant Banking Services.

2.12 MERCHANT BANKING ACTIVITIES :

Merchant Banking activities involves the following services.

1) Project Appraisal
2) Syndication of loan
3) Issue Management
4) Under writing of issues
5) Corporate Counselling
6) Mergers, Amalgamations and Acquisitions
7) Bankers to the issue
8) Investment counselling
9) Portfolio Management Services
10) Registar and Transfer Agent Services

1) PROJECT APPRAISAL :

Project appraisal is the process of examining the technical, commercial, financial and economic viability of a project to ensure that it generates sufficient returns on the resources invested in it. The study of the viability involves detailed verification of project's ability to stand the tests of technical, financial and commercial feasibilities and management's capabilities to successfully implement and run the product. Under this service project report will be prepared for the company including finalisation of capital structure.

2. SYNDICATION OF LOAN :

Estimating the Project's financial needs and structuring these into short and long term finance and equity capital to ensure ideal financial base and undertaking syndication of financial assistance, i.e., negotiating for assistance from financial institutions and commercial banks including preparation of detailed application forms.

Arranging for raising foreign exchange loans and external commercial borrowings for import of capital goods / components at attractive and competitive terms, through Indian/Foreign banks and external agencies.

3) ISSUE MANAGEMENT :

Assisting companies in arriving at quantum and nature of issue and obtaining consent / clearance from various statutory authorities, preparing draft prospectus, obtaining approval from appropriate authorities etc.

Assisting companies in tying up underwriting arrangements for the issue, appointing other intermediaries like brokers, bankers, advertising agents, registar to the issue, co-ordination of activities of these agencies and institutions for the successful floration of the issue.

Assisting in listing the securities in stock exchange, finalising basis of allotment, arranging for refund, handling investors complaints etc.

4) UNDERWRITING OF ISSUES :

In order to ensure full subscription or the stipulated minimum subscription of 90% of the offer companies enter into an agreement with financial institutions, banks, brokers and merchant bankers to underwrite the issue amount; i.e., requiring the latter to procure subscription from investors upto a specified sum or in the event of failure to do so, subscribe to the securities not taken up by the investors. Merchant Banker can underwrite issues and assist companies in tying up underwriting from other underwriters.

5) CORPORATE COUNSELLING :

Rendering assistance to corporate clients on various aspects of business operations particularly in the areas of financial planning, restructuring capital, performance budgeting, liquidity management, other aspects of financial management and monitoring systems, constitutes corporate counselling.

6) MERGER / ACQUISITIONS OR AMALGAMATIONS :

Some companies desire to restructure themselves in order to effectively meet competitions by adding synergies through a process of merger, acquisition or amalgamation. Merchant Banker provides all requisite guidance and services, for restructuring to prepare due diligence, obtain necessary clearance from statutory bodies like SEBI, ROC etc., as per the statutory and legal stipulations for the process of merger, acquisition or amalgamation.

7) BANKERS TO THE ISSUE :

Collection of subscription money / application money for an issue from the investors giving acknowledgement, proper accounting of the money received sending reports / certificates to issuing company and registrars, informing collection details etc., are the duties discharged as bankers to the issue.

8) INVESTMENT COUNSELLING :

This activity involves assisting individuals as well as firms, companies, trusts and funds (gratuity, super annuation, provident / pension fund) and associations in the choice of shares and stocks for investment depending upon the needs of the investor with proper blend of high yield and high growth shares on the one hand and the entitlements appertaining tax and investment incentives on the other.

9) PORTFOLIO MANAGEMENT :

The activity here relates to assisting firms, trusts, funds and associations and individual residents and non-residents in managing their portfolio investment by acting as agents in acquiring securities, shares and debentures, planning a basket of scrips in their portfolio by judicious selection after evaluating current and future returns and after providing for elements of risk and uncertainly : reviewing the mix of portfolio continuously to maximise returns and minimise risks in consultations with and after approval by the principals.

Assisting in particular, non-resident Indians by providing guidelines on the various types of accounts that can be opened in India with tax exemption facilities and investment proposals with similar tax exemption facilities, remittance facilities available by arranging for acquiring and managing securities abroad.

10. REGISTRAR AND TRANSFER AGENT SERVICES :

The following is the type of services provided collecting the application from bankers scrutinising, coding and verification of applications, finalising the basis of allotment of securities in consultation with stock exchange, finalising the list of persons entitled to allotment of securities, processing and despatching allotment letters, refund orders or certificates and other related documents in respect of an issue, attending to complaints of applicants.

Transfer agency work involves carrying out transfer work in respect of securities after complying with stipulated formalities / procedures. Preparation and printing of dividend warrants and despatching them to share holders also is covered here.

2.13 Merchant Banks are classified under four categories by the securities and exchange board of India (SEBI) namely

i) Those merchant banks with net worth of more than Rs. 1 crore which are allowed to function as lead managers, underwriters, consultants to issue of shares / debentures.

ii) Those with net worth of 50 Lakhs to Rs. 1 crore which are permitted to act as co-managers, advisor consultant to an issue. While they can provide services as underwriters they cannot act as lead managers.

iii) Those with net worth of more than Rs. 20 Lakhs and up to 8.50 Lakhs, are allowed to act as advisors and consultants to an issue.

iv) Those merchant banks for which no net worth norms are fixed are allowed to act as consultants and advisors for issue to shares / debentures

The guidelines for merchant bankers issued by the Government of India in April 1990 provided inter alia that any person or body corporate engageed in merchant banking business would need authorisation from securities.

EXCHANGE BOARD OF INDIA (SEBI) :

The SEBI is the regulatory authority for the activities of merchant bankers. The SEBI has introduced a core of conduct for merchant bankers, spcifying their obligations and responsibilities. The code of conduct includes standards of integrity and fairness in dealings of merchant bankers, ethical conduct of business and provision of information to the clients in terms of the code. It is also stipulated that no merchant bankers will indulge in any unfair competition harmful to other members of the profession or put them in any disadvantageous position while carrying out merchant banking business. The merchant banker is required to provide true and adequate information to investors and abide by the provisions of various acts, rules and regulations.

In the initial stages, merchant banking activities were concentrated on issue management, which offered good business opportunities. Gradually, merchant banking services have been extended

to cover other activities viz., counselling corporate clients who are in need of capital in respect of their capital structures, forms in which they can raise the capital and issue of prospectuses and publicity for boosting the issue for flotation in the market. Merchant banks also carry out such functions as private placement of capital, mergers and amalgamations, assistance to corporate sector in raising long term loans in foreign exchange or in rupee from the national and state level financial institutions, as also short term working capital from commercial banks. An association of merchant bankers called Association of Merchant Bankers of India (AMBI) has been established in Mumbai, with the objective to promote healthy development of merchant banking and to render assistance and provide common services, and to adopt / implement code of conduct for merchant banks. Foreign companies have been allowed to float merchant banking subsidiaries in India.

2.14 RECENT DEVELOPMENTS :

The dual regulations of merchant bankers has been done away with. Henceforth, the merchant bankers will only be regulated by securities and Exchange Board of India with the Reserve Bank of India exempting these financial services intermediaries from the RBI Act.

Merchant Bankers now exempted from RBI regulations will be required to be registered with the SEBI. They may acquire securities only as part of their merchant banking business and do not carry any other financial activities mentioned in 451 (c) of the RBI Act. They will also not be allowed to accept public deposits separately registered NBFC's can accept public deposits within limits.

INVESTMENT COMPANIES

Objective :

After going through this lesson you should be able to understand role and relevance of Investment Companies.

STRUCTURE :

2.15 Introduction
2.16 Activities of Investment Companies

2.15 INTRODUCTION :

Investment company means any company which is carrying on as its Principal Business, the acquisition of securities. The prudential norms as well as the ceiling on acceptance of deposits from the public have created hurdles in the operations of investment companies. Cholamandalam Investment and Finance Company Ltd., part of the Murugappa Group and Hinduja's Ashok Leyland Finance Ltd., have decided to enter the Asset securitisation market in a big way. Industry Leader Sundaram Finance Ltd., is actively considering this route.

2.16 ACTIVITIES OF INVESTMENT COMPANIES :

Investment companies are numerically the most important of NBFC's. Their functional coverage is narrow and specialised. Most of them give loans for consumption, commerce and trading purposes. The share of Industrial loans is negligible. They Finance important needs as house building, education and medical needs and priority sectors as small transport operators. Many

of these institutions have close and this puts them in a better position for the task of decentralising the Financial Structure of the country. The Interest rates charged by these Institutions for Fiancial assistance are higher than those charged by Commercial Banks and other organised Financial Institutions. They also offer higher rates of interest on deposits accepted by them. But the higher interest rate is not the only reason why people choose them for keeping their deposits. The other reason is the possibility of borrowing funds in amounts not linked with the volume of deposits or contributions of each borrower. Similarly they are in a position to get loan business inspite of higher interest rates because these loans are often unsecured and the procedures are simpler while bank finance is difficult to obtain. These Institutions get business because they create liabilities and assets which satisfy in a great measure non-financial preferences of lenders and borrowers. It would not be wrong to say that in such matters these Institutions form a segment within the organised Financial System similar to the unorganised money market.

The Question that arises is whether these Institutions pose any competition for the Commercial Banks. There is no easy answer to this question. As these Institutions do not usually accept demand deposits they do not compete with banks in this field. With regard to Time Deposits, however, since the return offered by them is higher some diversion from banks to these agencies cannot be altogether ruled out. The Banking Commission had pointed out that a part of their funds represents activisation of currency balances. The loan business of these Institutions is supplementary / complementary to that of Banks. They give loans to borrowers and for purposes which are shurned or inadequately catered to by the Banks.

Much attention has been paid in India to the problem of regulating and controlling these Institutions for two reasons (a) Their Managements have sometimes found to be dishonest and Depositers Interest have been neglected. (b) By giving Loans for the purpose of speculation and hoarding, they have tended to undermine the goals of monetary policy in the country.

This is how Investment companies are contributing their mettle to the Financial Sector.

DEVELOPMENT BANKS

Objective :

After going through this lesson you should be able to undurstand the meaning, functions, social objectives and structure of Development Banks in India.

STRUCTURE :

2.17 Meaning and Functions
2.18 Social Objectives
2.19 Structure of Development Banks of India

2.17 MEANING AND FUNCTIONS :

Economic Development of a country requires the expansion and easy availability of adequate financial resources of meet long-term capital needs to agriculture and industry. Development banks are set up specially to provide financial assistance for development projects both

(i) directly - a) by extending term loans and b) by subscribing to shares and debentures; as well as (ii) indirectly - a) by under writing of new issues and b) providing guarantees for term loans and deferred payments.

Development banks or term loans banks are the specialised financial institutions which serve twin objectives of a) performing banking functions and b) promoting economic development. As banks, they private finance but, the development banks are not ordinary banks. They are specialised institutions and are quite different from ordinary commercial banks :

i) Development banks do not accept deposits from the general public as the commercial banks do.
ii) Development banks provide medium-term and long-term finance whereas commercial banks provide short-term loans.
iii) Unlike other financial institutions, the development banks not only provide term finance, but also perform developmental and promotional functions.

Development banks are development-oriented banks. They not only provide long term finance, but also have a development role to play through promoting investment and enterprise in different sectors of the economy. These banks a) provide risk capital; b) underwrite new issues; c) give guarantee for term loans and deferred payments; d) make arrangement for foreign exchange loans; e) identify investment projects; f) prepare and evaluate project reports; g) provide technical advice, market information and management services. Indian development banks have not yet developed enough to extend all these development services.

2.18 SOCIAL OBJECTIVES :

Development banks are expected to formulate their lending policies and direct their general operations in accordance with the broad Socio-economic objectives of the country. They must actively participate in the realisation of these objectives. In India the social objectives of the development banks are to serve the following areas on a priority basis;

i) Projects in the backward regions
ii) Projects in the small scale sector
iii) Projects started by new technicians and entrepreneurs;
iv) Projects providing mass consumption products;
v) Projects relating to export promotion and import substitution programmes.

In addition to serving these priority areas, the development banks have also to prepare their lending, strategy in such a manner as not to create inflationary pressures in the economy; or not to create idle capacity in certain sectors or not to create conditions of shortages and gluts of certain products.

2.19 STRUCTURE OF DEVELOPMENT BANKS OF INDIA :

Development banks in India (with the exception of land development banks) have developed in the post-independence period. The structure of Indian development banks can be divided into two broad categories : a) those which promote agricultural development; and b) those which promote industrial development.

1. Agricultural Development Banks :

Agricultural development banks in India are further classified into three heads.

i) At all India Level; National Bank for Agricultural and Rural Development [NABAD].

ii) At state level; State Land Development Banks [SLDBs].

iii) At local level; Primary Land Development Banks [PLDBs) and branches of State Land Development Banks [SLDBs].

2. Industrial Development Banks :

Industrial Development Banks in India are also divided into two groups

i) At all India Level; Industrial Finance Corporation of India [IFCI]. Industrial Development Bank of India [IDBI], Industrial Credit and Investment Corporation of India [ICICI], Industrial Reconstruction Bank of India [IRBI].

ii) At State Level; State Finance Corporations [SFCs], and State Industrial Development Corporations [SIDCs].

INDIAN STOCK MARKETS

OBJECTIVES :

After going through this lesson, you will get a Bird's Eye view of the Indian Stock Markets, its functions and importance. You will understand salient features of securities control (Regulations Act CSCR Act) 1956 and functioning of the NSE. Further you will understand the ON LINE TRADING, FUTURES AND DERIVATIVES AND THEIR PROSPECTS.

STRUCTURE :

2.20 Introduction
2.21 Functions of Stock Exchanges
2.22 History And Development of Stock Exchanges
2.23 Organisation Of Stock Exchanges
2.24 Securities Control (Regulation) Act 1956.
2.25 Powers of The Central Government
2.26 Bye Laws
2.27 Recognition By Government
2.28 Securities Contracts (Regulation) Rules 1957
2.29 Membership Rules Under SCR Act
2.30 National Stock Exchange (NSE)
2.31 Promoters
2.32 Market Segments of NSE
2.33 Salient Features of Trading Systems At NSE
2.34 Listing
2.35 Trading Mechanisms At The NSE
2.36 NSE Membership
2.37 On Line Trading

2.38 Order Routing System (ORS)
2.39 Procedure In On Line Trading
2.40 Advantages of On Line Trading
2.41 Disadvantages of On Line Trading
2.42 Control By SEBI
2.43 Prospects of On Line Trading In India
2.44 Futures And Derivatives

2.20 INTRODUCTION :

The Market for long term securities like Bonds, Equity stocks and preferred stocks is divided into Primary Market and Secondary Market. The primary market deals with the new issues of securities. Outstanding securities are traded in the Secondary market, which is commonly known as Stock market or Stock Exchange. In the Secondary Market, the Investors can sell and buy securities. Stock markets predominatly deal in the Equity shares. Debt instruments like Bonds and Debentures are also traded in the Stock Market. Well regulated and active Stock Market promotes capital formation. Growth of the Primary Market depends on the Secondary Market. The health of the economy is reflected by the growth of the Stock Market..

2.21 FUNCTIONS OF STOCK EXCHANGES :

1) MAINTAINS ACTIVE TRADING :

Shares are traded on the Stock exchanges, enabling the Investors to buy and sell securities. The prices may vary from transaction to transaction. A continuous trading increases the liquidity or marketability of the shares traded on the Stock exchanges.

2) FIXATION OF PRICES :

Price is determined by the transactions that flow from Investors demand and suppliers preferences. Usually the traded prices are made known to the public. This helps the investors to make better decisions.

3) ENSURES SAFE AND FAIR TRADING :

The rules, regulations and By-laws of the Stock exchanges provide a measure of safety to the Investors. Transactions are conducted under competitive conditions enabling the Investors to get a fair deal.

3) AIDS IN FINANCING THE INDUSTRY :

A continuous market for shares provides a favourable climate for raising capital. The negotiability and transferability of the securities helps the companies to raise long term funds. When it is easy to trade the securities investors are willing to subscribe to the initial public offerings. This stimulate capital formation.

4) DISSEMINATION OF INFORMATION :

Stock exchanges provide Information through their various publications. They publish the share prices traded on daily basis along with the volume traded. Directory of corporate information is useful for the Investors assessment regarding the corporate. Hand outs, hand books and pamphlets provide information regarding the functioning of the Stock exchanges.

5) PERFORMANCE INDUCER :

The prices of stocks reflect the performance of the Traded companies. This makes the corporate more concerned with its public image and tries to maintain good performance.

6) SELF - REGULATING ORGANIZATION :

The Stock exchanges monitor the Integrity of the members, bankers, listed companies and clients Continuous Internal Audit safeguards the Investors against unfair trade practices. It settles the disputes between member brokers, investors and brokers.

2.22 HISTORY AND DEVELOPMENT OF STOCK EXCHANGES :

The credit of starting the earliest transactions in securities goes to East India Company in the 18th century end. However, the actual stock market transactions were started by the legislation of companies Act in 1856. The stock market witnessed many booms and depressions before the organised stock exchanges came into being.

Calcutta Stock exchange was established in 1830 and stock exchanges at Bombay and Ahmedabad were set up in 1875 and 1894 respectively. These were organised as voluntary non-profit making associations of brokers to regulate and protect their interests. A need for organised body was felt for the mutual protection and safety of the brokers and the trade which gave birth to "CALCUTTA Stock Exchange Association, in June 1908. Till 1950, Control and Regulation of stock market was a state subject and the Bombay Securities Contracts (Control) Act of 1925 used to regulate trading in securities. Under this Act, the Mumbai Stock Exchange was recognised in 1927 and Ahmedabad in 1937. Under the New constitution in 1950, it became a central subject and a committee headed by A.D. GORWALA went into the Bill for securities regulation. On the basis of the committee's recommendations, the Securities Contracts (Regulation) Act became law in 1956.

Due to out break of First World War, the Indian Stock Market almost became defunct and non-existent and the number of members reduced from hundred to three in 1923.

The Stock Market activity was later revived in 1935 with the increases in Textile Mills and many new plantation companies that have come up in South India. A need arose to cater to the growing trade in plantation and Mill shares and this has lead to the formation of "MADRAS STOCK EXCHANGE ASSOCIATION (PVT) LTD., on 4th September 1937.

Four more Stock Exchanges were set up in Ahmedabad during the Second World War period. Calcutta and Delhi had two stock exchanges besides the existing ones. In 1940 two stock exchanges namely the U.P Stock Exchange Limited and the Nagpur Stock Exchange Limited were established in Kanpur and Nagpur respectively. In 1944 the Hyderabad Stock Exchange Limited was incorporated in Hyderabad as a company limited by guarantee and recognised under the Hyderabad Securities Contracts Control Act modeled on the Lines of the Bombay Securities Contracts Control Act of 1925. A small Stock Exchange also sprang up in Bangalore city.

But this proliferation did not last long as many Stock Exchanges withered away by 1957. Though all the Stock Exchanges applied for recognition to the Central Government under the Securities Contracts (Regulation) Act (SCB Act 1956). Only the old established stock exchanges in Bombay, Calcutta, Madras, Ahmedabad, Delhi, Hyderabad and Indore were recognised under this Act. The Bangalore Stock Exchange Ltd. were recognised subsequently in 1957 and recognised in 1963.

2.23 ORGANISATION OF STOCK EXCHANGES :

Some of the recognised Stock Exchanges in Bombay, Ahmedabad and Indore are voluntary non-profit organizations whereas those situated in Calcutta, Delhi and Bangalore function as Joint Stock companies, limited by shares and Stock Exchanges functioning in Madras and Hyderabad are formed as companies limited by guarantee. Uniformity in their organization is ensured through Articles of Association which define the constitution of the recognised stock exchanges. The Bombay stock exchange was the first to get permanent recognition followed by Calcutta, Delhi, Madras, Ahmedabad, Hyderabad, Indore and Bangalore. The other exchanges were given at the first instance official recognition for a period of five years and at the end of each term the recognition has been renewed for another five year period.

At present, there are more than 24 Stock Exchanges in India. As per the present guidelines, the proposed region in which the Stock Exchange is to be set up must be industrially developed with a sizable number of industrial units and should be able to attract atleast 50 companies Independently.

2.24 SECURITIES CONTROL (REGULATION) ACT 1956 :

The securities contracts (Regulation) Act is formed in 1956 with the main objective of controlling and regulating the activities of stock exchanges in India. The Act sets up a general framework of control which makes Government influence all pervasive. Every stock exchange has to be recognised under SCR before it starts it operations. Stock Exchange means any Body or Individuals whether incorporated or not constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. It is an association of member brokers for the purpose of self-regulation and protecting the interests of members.

2.25 POWERS OF THE CENTRAL GOVERNMENT :

The Central Government is vested with the following powers :

1) Grant and withdrawal of recognition, approval or change of Byelaws.
2) Call for periodical returns from the Stock Exchange.
3) Direct enquiries on the members or on the stock exchange.
4) Liability of the Exchange to submit Annual Reports.
5) Directing the Stock Exchange to make certain rules.
6) Supersede the Governing Board of the Exchange.
7) Suspend the Governing Board of the Exchange.
8) Impose any other conditions or regulations for trading.

2.26 BYE LAWS :

Besides the above Act, the securities contracts (Regulation) Rules were also made in 1957 to regulate certain matters of trading on Stock Exchanges. These are also Byelaws of the Exchange which are concerned with the following areas :

1) Opening/Closing of the Stock Exchange
2) Tuning of trading
3) Regulation of blank transfers
4) Regulation of Badla or carry over business
5) Control of the settlement and other activities of the Stock Exchange

6) Fixation of Margins, Fixation of Market prices or making up prices.
7) Regulation of Taravani Business etc.,
8) Regulation of Brokers trading
9) Brokerage charges, Trading rules on the Exchange
10) Arbitration and settlement of disputes
11) Settlement and clearing of the trading etc.,

2.27 RECOGNITION BY THE GOVERNMENT :

As mentioned earlier, a stock exchange is recognised only after the Government satisfied that its Rules and Byelaws conform to the conditions prescribed for ensuring the dealings and protection to Investors. Government has also to be satisfied that it would be in the interests of the trade and public interest to grant such recognition. Mumbai, Calcutta, Delhi, Chennai, Ahmedabad, Hyderabad, Bangalore, Indore etc., have so far been granted permanent recognition.

The rules can be amended, varied or rescinded only with the approval of the Government. Like wise, the Byelaws of the recognised Exchanges in detail for the regulation and control of contracts in securities and for even of the trading activities of members must also be sanctioned by Governments amendments or modifications must be similarly approved. The Act empowered the Government with power to make enquiries into the affairs of a recognised Stock Exchange members to supersede the Governing Body and take over the property of an Exchange, to suspend its Business and finally to withdraw the recognition to an Exchange should such steps be deemed indispensable in the public Interest.

2.28 SECURITIES CONTRACTS (REGULATION) RULES 1957 :

Under this Act, Government has promulgated the Securities Contracts (Regulation) Rules 1957 for fulfilling the objectives of the Legislation. These rules prescribe the procedure to be followed for

1) Recognition of Stock Exchanges
2) Submission of periodical returns and annual reports by recognised Stock Exchanges
3) Inquiry into the affairs of recognised Stock Exchanges and their members and
4) Requirements for listing of securities

The Rules are statutory and applied uniformly to all the recognised Stock Exchanges.

2.29 MEMBERSHIP RULES UNDER SCR ACT :

The regulations governing the admission of members of the Recognised Stock Exchanges are uniform in terms of the provisions of the Securities Contracts (Regulation) Rules 1957. These Statutory Rules provide that no person shall be eligible to be elected as a member if he is

1) Less than 21 years of Age.
2) Not an Indian citizen.
3) Adjudged Bankrupt or proved to be insolvent or has compounded with his creditors.
4) Convicted of an offence involving fraud or dis-honesty.
5) Engaged as Principal or Employee in any business other than that of securities.
6) Member of any other association in India where dealings in securities are carried on.
7) Director or Employee of companies whose principal business is that of dealing in securities.
8) Firms and companies are not eligible for membership of a recognised Stock Exchange.

9) Lastly, individuals are ordinally not deemed to be qualified unless they have had atleast two years market experience as an apprentice or as a partner or authorised assistant or authorised clerk.

2.30 NATIONAL STOCK EXCHANGE (NSE) :

The National Stock Exchange of India Limited was set up with the primary idea of facilitating computerised trading in Debt market Instruments. It was incorporated in Nov 92 by IDBI and other All India Financial Institutions and because recognised Stock Exchange from April 26, 1993 to provide Nationwide Stock Trading facilities. The NSE has a fully automated screen based trading system and operates on the principles of an order driven market. NSE is the outcome of the recommendations of Shri M.J. PHERWANI committee. It is expected to operate as a Model Stock Exchange and to provide a nationally integrated Stock Market system facilitating an easy flow of transactions and resources on a cost effective manner.

2.31 PROMOTORS :

Following leading Financial Institutions are the promotors of National Stock Exchange (NSE)

1) Industrial Development Bank of India.
2) Industrial Finance Corporation of India.
3) Industrial Credit And Investment Corporation of India.
4) Life Insurance Corporation of India.
5) General Insurance Corporation of India.
6) SBI Capital Markets Limited.
7) Stock Holding Corporation of India Ltd.,
8) Infrastructural Leasing And Financial Services Ltd.,

2.32 MARKET SEGMENTS OF N.S.E :

The National Stock Exchange was intended to establish a viable and vibrant debt market which was in an underdeveloped staze. It provides the traditional retail market for securities and also operates a wholesale Debt market (which may be termed as money market segment). The National Stock Exchange as conceived consists of three naturally exclusive segments.

1) Wholesale Debt Market segment
2) Capital Market segment
3) Futures and options trading

2.33 SALIENT FEATURES OF TRADING SYSTEM AT NSE :

The NSE has a fully automated screen-based trading system. It operates on the principle of an order driven market providing complete flexibility to the members in the kind of orders that can be placed by them. The total systems solutions adopted by the NSE involves a technology which is the state of Act.

The NSE does not have trading floors as in conventional Stock exchanges. The trading entirely screen based with automated order matching. The screen provides entire market information at the press of a button which the existing Telephone trade or Trading floor cannot provide instantaneously. At the sametime the system provides for concealment of the identy of market operators.

The Trading system of the NSE is known as National Stock Exchange of Automated Trading. The NSE is connected through a VSAT (Very Small Earth Based Aperture Terminal) or through leased telephone Lines.

2.34 LISTING :

The term listing means admission of securities of a company to dealing on a recognized Stock Exchange. The principal objective of listing is to provide liquidity and marketability to listed securities and ensure effective monitoring of trading for the benefits of all participants in the market.

A company desiring to get listing at the NSE has to enter into listing agreement and is required to pay the specified listing fees. There after the company is required to comply with all clauses of the listing agreement and to send details of book closure, record dates etc., a copy of annual report half-yearly reports and cash flow statements.

The securities of any entity may be listed at any of the following stazes :

1) At the time of public issue of shares 1 debentures.
2) At the time of right issue of shares 1 debentures.
3) At the time of Bonus issue.
4) Shared issued on Amalgamations 1 Merger.

2.35 TRADING MECHANISM AT THE NSE :

The NSE is a completely online screen based trading system accessible to all its trading members on equal time basis. The Tele communications link, connecting the trading, work station on trading member premises to the NSE's mainframe computer in Mumbai, is of crucial importance for the exchange to provide on live responses within a few seconds. The permission to applicants selected as trading members to trade on the Exchange is act ordered in Groups as Telecom Network expands progressively to cover all eligible trading members. The NSE's VSAT Telecommunication Network works as a closed user group and is available only to its members. For trading on the system, the trading member will also require a work station which he is expected to purchase along with requisite software. The trading system provides enormous flexibility to trading members. While entering the order, a trading member can place various conditions on the order.

2.36 NSE MEMBERSHIP :

At the NSE, operations are segmented into the wholesale debt and capital market. Professional capability of members to provide desired results of services to investors is the Bench Mark of obtaining membership of NSE. The Admission criteria for NSE membership is different for the two segments and takes into account Financial adequacy, Infrastructural ability back ground, experience and education.

NATIONAL STOCK EXCHANGE BENEFITS TO TRADING MEMBERS :

1) They can provide efficient service to their clients.
2) Their back office load is reduced considerably.
3) There will be no need to occupy office premises near the exchange unlike at present and thus can load reduced establishment cost.
4) The system will assure best practice to participate in the Market.
5) Settlement will be quick and efficient.

TO INVESTORS :

1) The Investor is assured of best price in the Market.
2) Price and brokerage are separately shown on Contract notes.
3) Date and Time of trade are indicated.
4) The system is better mentioned and regulated ensuring a fair deal to Investors.
5) Safety of securities is enhanced in a depository and there will be no problems of bad delivery loss, theft or forgery.

TO ISSUERS :

1) By a single listing they can provide nation wide access to their Investors.
2) As a result their listing costs are reduced considerably.
3) Issuers will have high visibility.

2.37 ON LINE TRADING :

Using the Net as a medium for communicating client orders to the Stock exchanges through Broker websites is called on-line Stock trading Value added services like on line stock quoter, Companies Financial Information and Analysis etc., are also provided by such broker sites apart from full trading through the website. The on-line trading provides an opportunity to leverage an unparalleled immediacy, flexibility and Transparency to reach out the Investors spread throughout the country. In western markets like the US about 40 percent of transactions are executed through on line. In India too Internet trading has taken off in a big way by the initiative taken by most of the Big Stock Exchanges. The premier exchanges in India Viz, Bombay Stock Exchange (BSE) and the National Stock Exchange of India (NSE) are embracing the internet in an effort to leverage the power of this medium to reach out to the untapped masses by taking the Stock Trading to the desktop.

2.38 ORDER ROUTING SYSTEM (ORS) :

Using the Internet as a route for elient orders to Stock exchanges through a registered broker on behalf of clients for execution of trader is called ORDER ROUTING SYSTEM (ORS). In this system, a broker who opens a website, offers Internet Trading Facility through an electronic template. In ORS, a broker offering internet trading facility provides an Electronic Template /space for the customer to enter the name of the security whether it is to be bought or sold and the quantity and price specifications. Once the Broker's system receives the information, it is checked electronically against the customer's account and is routed to the appropriate exchange for execution by the broker. After the order is executed, the customer receives a message confirming the order. The customer's portfolio and ledger account may also be updated on line to reflect the transaction. The main benefit of ORS is that, an investor will have control over the information and quotes and will be able to hit the quote on an on line basis. This ensures reliability confidence in the capability or intention of the broker. There is no need for re-confirming the 'tip' the broker gave and no more running over missed chances.

2.39 PROCEDURE IN ONLINE TRADING :

As a matter of practice, a provision or space is made in the website for the customer to enter the name of the security, whether he would like to buy or sell, quantity and price at which securities are intended to be bought or sold. The information so furnished by the customer would be checked electronically against the customer's account and is routed to the appropriate stock exchange for

execution by the broker. After the execution of the order, a message is sent to the customer, through e-mail at the time specified by the client confirming the order. The customer's Portfolio and Ledger account would also be updated on line to reflect the transaction. The Investor would be allowed to specify the time interval on the web site itself within which he would like to receive this information through E-mail. The broker system would be capable of assessing the risk of the client as soon as the order comes in. The client would be informed of acceptance/rejection of the order within a reasonable period. Reports on margin requirements payment and delivery obligations and so on would be informed to the client through the system. As a matter of abundant precaution, brokers using Internet based systems for routing client orders will also not be allowed cross trades of their clients with each other, that is they have to go through the exchange for matching.

2.40 ADVANTAGES OF ON LINE TRADING :

1) INDEPENDENT DECISIONS :

With on line trading the basic requirements are a PC and a modem, one can log on to an on line Trading portal, go through a comprehensive database of information. Use the online analytical tools and pass on the instructions to the broker.

2) ECONOMICAL :

On line Trading really is the perfect combination of the medium of the Net catering to a real life concept. All the information with regard to company's performance to the Industrial and Economic scenerios the net usually is the perfect solution to investor needs.

3) CONVENIENT :

On line Trading enables one and all to make trades right from any one's home. The ease of transaction also makes is highly pragmatic.

4) FAST MOBILISATION OF RESOURCES :

On line Trading also has a role to play in Economic Factors such as the mobilisation of savings.

5) END TO FRAUDULENT PRACTICES :

The Investors are well equipped with the latest information about the changes in the companies financial position and stock quotes and would be able to hit the quote on an on line basis. Such a system puts a fullstop to the various types of malpractices to which customers were subjected at present. The individual customers can dependent on their wisdom, capacities and take right timely decisions.

2.41 DISADVANTAGES OF ON LINE TRADING :

1) LACK OF SECURITY
2) EASY MANIPULATION
3) EXPENSIVE

2.42 CONTROL BY SEBI :

SEBI formulated rules and regulations to be adhered to both by customers and brokers in such a way that malpractices on any side are minimised. It made it mandatory for the Broker websites

to contain arbitration rules, Investor protection rules and links to the relevant Stock exchange site displaying all the rules and regulations. To ensure the financial soundness of the brokers setting up the online service, SEBI stipulated minimum networth requirements of brokers to support volumes generated through Internet orders. A minimum net worth of Rs. 50 lakhs is mandatory for an individual broker and for a team of brokers, the minimum net worth is decided by the relevant Stock Exchange/ Stock Exchanges.

The market regulator made it mandatory for the online system to have security, reliability, and confidentiality of data through the use of Encryption Technology before the Net Trading begins.

2.43 PROSPECTS OF ON LINE TRADING IN INDIA :

On line Trading essentially provides investors multiple access points through the net and further exponential growth in the numbers of Investors and the amounts invested is sure to increase in close connection with the increase in Net penetration in India. Improvements in infrastructure, reduction in cost of hardware and the consequent proliferation of cyber cafes across the country will enable investors in smaller towns across India to experience the phenomenon of on line trading. With increased Internet penefration in India on line trading with multifaceted advantages of convenience, 24 hours availability and case of Transaction is poised to grow exponentially.

2.44 FUTURES AND DERIVATIVES :

Various types of contracts are in vogue in markets for commodities and financial instruments. In India, the FCRA or Forward Contracts (Regulation 7 Act 1952) classifies different types of contracts as follows (1) Ready Delivery Contract (RDC) which provides for delivery of goods/instruments and payment of a price thereafter either immediately or within 11 days after the time of contract. It also leads to spot or cash transactions which take place at current commodity price or interest rate or exchange rate and so on. (2) Forward Contract (FC). It is a contract for delivering goods and is not a RDC. It is also known as a Specific Delivery Contract (SDC). Forward Transactions are spot transactions which are deferred for execution to a future but fixed date. The SDC is of two types. (a) Non-Transferable Specific Delivery Contract (NTSDC) in which rights and liabilities mentioned in contracts and not transferable.

Derivations or Derivative securities are contracts which one written between two parties (counter parties) and whose value is derived from the value of underlying widely held and easily marketable assets such as Agricultural and other Physical Commodities or Curricucies or Short Term and Long Term Financial Instruments or intangible things like commodities price Index, Equity Price Index or Bond price Index. The counter parties to such contracts are those other than the original Issuer (holder) of the underlying asset. Derivatives are also known as “deferred delivery or deferred payment systems”. In a sense, they are similar to securitised assets, but unlike the latter, they are not the obligations which are backed by the original Issuer of the underlying asset a security.

LIST OF RECOGNISED STOCK EXCHANGES IN INDIA ADDRESSES AND DATE RECOGNITION

S.No.	Name & Address Of the Exchange	Office Telephone Telex / Fax	Date of Recognition	Approx.No Of Members
01.	The Ahmedabad Stock Exchange, Kamadhenu Complex, shahajanand Complex, Panjara Pole Ahmedabad - 380 008	26561856 STD : 079 TLX : 0121 - 6789 ASEX : 100 FAX : 079 GRAM : SHARATION	16-09-57	299
02.	The Stock Exchange (BSE) Priroze Jee Jee Bhoy Towers, Dalal Street, Mumbai - 400 001	2270563/2275581 STD : 022 TLX : 0212 - 8925 Fax : 022 - 275981 GRAM : SHARATION	31-08-57	533
03.	The Bangalore Stock Exchange Limited, Uni Building Miller Tank, Bangalore - 560 052.	2225687, 2226577 2222637, 2326631 2227338, 2222137 STD : 080 TLX : 080 - 2874 (BSE IN) GRAM : BANGSTOCKS	16-2-63	223
04.	The Bhubaneswar Stock Exchange Assn. Ltd., 217, Bhudaraja Building Jharpada, Cuttack Road, Bhubaneswar - 751 006	252340/41, 255140 254140 STD : 0674 TLX : 0675 - 437 GRAM : STOCKEX	5-6-89	300
05.	The Calcutta Stock Exchange Association Ltd., 7. Lyons Range, Calcutta - 700 001.	2203335, 2201488 2206977, 2206957, 2201489, 2209368 3202514 STD : 033 TLX : 021 - 74714 FAX : 033 - 283724 GRAM : CLASTOCK	10-5-59	726

06.	The Cochin Stock Exchange Ltd., Exchange House, Veekshanam Road, Ernakulam P.B. No. 3529 Cochin - 680 035 Kerala.	GRAM : STOCK	– – –	– – –
07.	The Coimbatore Stock Exchange Ltd., Chamber of Commerce Building, 8/732 Avanashi Road, Coimbatore - 641 018.	2215100, 2215101 STD : 0422 TLX : 0855 - 503 FAX : 0422 - 221130 GRAM : CHAMBER	1991	200
08.	The Delhi Stock Exchange Ltd., 344/4B Asaf Ali Road, New Delhi - 110 002.	25715150/25103 23266845/23271038 23270600/23277708 23271302/2327900 23272493/23265542 STD : OIL TLX : 031 - 55317 FAX : 011 - 3267112 GRAM : UPKARI	9-12-59	375
09.	The Gauhati Stock Exchange Ltd., Saraf Building, Annex A.T. Road, Gauhati - 781 001	233667, 233672 233670 STD : 0361 TLX : 0235 - 2412 GRAM : STOCKS	1-3-84	126
10	The Hyderabad Stock Exchange Ltd., 3-6-275, Himayat Nagar, Hyderabad - 500 029.	236707 Tradiry Hall 231985 236746, 235079 STD : 040 TLX : 0425 - 6053 GRAM : STOCK EXCHANGE	29-9-58	180
11.	The Jaipur Stock Exchange Ltd., Indira Place, Malaviya Nagar, Jaipur - 320 017.	2552779, 2720367 STD : 0141 TLX : 0365 - 2648 GRAM : JAI STOCK	9-1-89	600

12.	The Mangalore Stock Exchange Ltd., 4th Floor, RamBhavan Complex, Kodal Bail, Mangalore - 575 003.	235853, 235613 235614 STD : 0284 FAX : 0824 - 34736 STOCKANARA (GRAM)	9-9-58	60
13.	The Ludhiana Stock Exchange Assn. Ltd., Phiroze Gawdhi Market, Clock Tower, Ludhiyana.	239318, 239319 2404748 STD : 0161 GRAM : DEALWELL	29-4-83	220
14.	The Madras Stock Exchange Ltd., Exchange Building, P.B. No. 183, 11, Second Lane, Beach, Chennai - 600 001.	2512237, 2510845 2514897, 2513081 STD : 044 - 514897 GRAM : MASTEX	15-10-59	166
15.	The Madhya Pradesh Stock Exchange Ltd., Rajani Bhavan, 3rd Floor, M.G. Road, Opp. High Court, Indore - 452 001.	237423, 221773 STD : 0731 GRAM : INDSTEX	24-12-58	72
16.	The Magadh Stock Exchange Ltd., Bihar Industries Association Premises, P.B. No. 7 Patna - 800 001.	2262312, 2262320 2223644, 2222852 STD : 0612 GRAM : MAGEXCMANGE	01-12-86	187
17.	The Meerut Stock Not Exchange Ltd., Functional Kingsway Building 345, Bombay Bazar, Meerut Canti - 250 001.	273633 STD : 0121		
18.	The Pune STock Exchange Ltd., Shivleela Chambers 752, Sadashiv Path, R.B Kumthekar Marg Pune - 411030	STD : 0212 2421584, 2858585 2441679 FAX : 0212 - 430764 GRAM : STOCKEX	2-9-82	73

19.	The Saurashtra Kutch Stock Exchange Ltd., 21, New Jagnath Dr. Yagnik Road, Rajkot - 360 002.	248176, 242145 STD : 0281 TELEX 0169 - 352 SKSE IN	July 89	300
20.	Thu U.P. Stock Exchange Association Ltd., Padam Towers 14/113, Civil Lines, Kanpur - 208 001	2210133 2210882, 2210601 STD : 0512 GRAM : SHARE BAZAR	3-6-82	445
21.	The Vadodara Stock Exchange Ltd., 101, Paradise Complex, Opp. Commercial College, Tilak Road, Sayaji ganj Baroda - 390 005.	2324334 (P) 2327501 (E.D) STD : 0285 GRAM : Fair Deal	1990	300
22.	Over the Counter Exchange of India (OTCEI) 92-93, Maker Towers F, Cuffe Parade, Mumbai - 400 005.	22188164/654/66 22188023 STD : 023	23-8-89	1000
23.	National Stock Exchange of India Ltd., (NSE), Mahindra Towers, Near Doordarshan T.V. Tower, 1st Floor, A. Wing Kbc Worli Mumbai - 400 018.	24928405 24932556 24932578 STD : 022 FAX : 24935631	26-4-93	400
24.	The Inter Connected Stock Exchange of India Ltd., (ICSE) Silvar Arcade, 3rd Floor 147, Marol Maroshi Road, Andheri, East, Mumbai - 400 059.	28593671, 28593688 STD : 022 FAX : 8591879	21-10-97	

MUTUAL FUNDS

Objective :

After going through this lesson you will be able to understand about the Mutual Funds Industry in India and its role and relevance in mobilizing small scale savings.

STRUCTURE :

2.45 Introduction
2.46 Mutual Fund in Public Sector - U.T.I. & L.I.C
2.47 Mutual Funds in Private Sector

2.45 INTRODUCTION :

Mobilization of funds by organizations in Public Sector and Private Sector for purposes of Investment in Stock Market securities so as to give adequate return to the investors who cannot invest directly. Entire mutual fund industry can be divided into three categories 1) UNIT TRUST OF INDIA 2) PUBLIC SECTOR MUTUAL FUNDS 3) PRIVATE SECTOR MUTUAL FUNDS. Unit Trust of India is maintaining total 59 schemes. Public Sector Mutual Funds is 74 in vogue. Where as Private Sector Mutual Funds consists of 337 schemes. Total number of schemes on 1st Dec. 2003 are 470. Prominent among them are Unit Trust of India.

2.46 Unit Trust of India : UTI :

The Unit Trust of India has established under the unit trust of India Act, 1963 with the objective of encouraging savings and investment as also participation in the income, profits and gains accruing to the Trust from holding management and disposal of securities. Thus the primary aim was stimulating investment interest among small investors who could not because of lack of knowledge and small capital take interest in the growth of any industry. The units offer the small investor the triple advantage of safety, steady return and liquidity in which not only is the safety of the investor's funds assured but the ordinary middle class individual investors have the benefit of leaving the task of selection of scrips for investments to the experts of the UTI. Thus it has proved a constructive from of investment of middle class groups who are not too familiar with the technical problems and intricacies of investment operations of share markets.

The UTI's activities include among others selling and purchasing of units, investing in securities, short-term and long-term debt financing. UTI mobilises the saving of the community through the sale of its units under different schemes. These schemes are then invested in the shares and debentures of good companies for the benefit of unit holders. Income from these investments after meeting the expenses of the trust is distributed to the unit holders anually as dividend.

UTI currently manages more than 50 schemes and its corpus is of the order of more than Rs. 60,000 crore. An important development during the last year was the setting up of Asset Management Committees [AMC] by UTI, viz., Asset Management Committee for the unit scheme, 1964, Asset management committee for Domestic Equity Schemes and Asset Management Committee for Domestic income/Debt Scheme. The AMC's will review the investment operations and the risk

return performance of the various schemes under its preview. It will also ensure adherence to the UTI Act SEBT (Mutual Fund) Guideline, exposure and asset quality norms and commitments made in the offer Documents each AMC would meet at least once in two months and review each scheme under its purview at least once every three months. The AMCs would make such recommendations to the Executive Committee / Board of Trustees as it may consider necessary.

Some of the schemes being operated by UTI as under

- Unit scheme, 1964
- Unit linked Insurance plan
- Scheme for charitable and religious trusts
- Unit Scheme 1992
- Master Gain Scheme
- Master Equity Plan
- Venture Capital Unit Scheme
- Institutional Investor's Special Fund Unit Scheme
- Children's College and Career Funds

UTI Restructuring :

UTI, Country's largest Mutual Fund in an un-precedented move suspended scale and purchase of U.S. 64 in June 01 sending shockwaves across the country. The move to suspend U.S. 64 was aimed at achieving the twin objectives to restructure the investment portfolio of the scheme in the face of volatile stock market as well as to wait for the market to become stable so that the equity investment of U.S. 64 fetch high returns. Since then things were not hunky dory for the trust.

There were more than 20 million investors in U.S. 64 with a total investment of Rs. 20,000 crores. Investment in U.S. 64 was little more than 25% of the total fund of Rs. 75,000 crores managed by UTI. Unlike other schemes U.S. 64 was not linked to NAV and many times higher rewards were given to unit holders by dipping into the services of the trust. It is reported that many investment decisions were taken by UTI without sufficient financial prudence and sound analytical basis. It is also reported that individuals took many investment decisions defying the views of evaluation committee.

Things were not good for UTI since the beginning of liberalization. In 1998 Government sanctioned a bailout package of Rs. 3300 crores to restore health of UTI. DEEPAK PAREKH Committee recommended UTI to restructure its Investment portfolio to fixed Income securities and move to a Net Asset Value (NAV) based system. The committee suggested that UTI bring its operations under the supervision of SEBI. The excessive investment in equity (roughly 2/3rd) is found to be inconsistent with its investment objective namely steady return of Income.

Being a behemoth in capital market the problem of UTI led to steep fall in prices of many shares and drastic erosion in market capitalization. Since UTI does not have sufficient funds to deploy, the share prices of many corporates are subdued despite better financial results. Following uncertainity surrounding the fate of UTI, the redemptions were huge and for the first time the total investment in UTI has fallen below Rs. 50,000 crores out of Rs. 1,00,000 crores investment in the Mutual Fund Industry. Govt. has decided to bail out UTI once again inorder to project the interest of investors and restore their confidence. For this purpose Y.H. MALEGAM Committee was asked to

review the recommendations of Deepak Parekh Committee and suggest follow up action while Tarapore Committee was asked to look into UTI's Investment over the past 10 years to find it extreneous considerations played a role in the Trust's Investment decisions. The committees suggested the follows.

Y.H. MALEGAM COMMITTEE :-

1. Three tier structure in line with SEBI regulations comprising a sponsor, a Trustee company and an Asset Management Company (AMC).
2. U.S. 64 to be Net Asset Value based before UTI restructing. Before shifting to NAV mode appropriate provisions should be made to meet shortfall arising out of the gap between the available assets of U.S. 64 and the guaranteed price to individual unit holders owing upto 3000 units.
3. The UTI Act should be repealed and a new Act to be enacted. Government must be completely distanced from UTI.

TARAPORE COMMITTEE :-

(1) Setting up of Board of Trustees and three Asset Management Companies one each for Income funds, growth funds and U.S. 64.

(2) UTI could hold 49% of the capital of the Three AMC's and this would overtime, enable greater private participation in UTI.

(3) UTI should empower AMC committees and take on responsibilities of Investment decisions before the move to a NAV basis in January 2002.

(4) Only individual Investor should be allowed into U.S. 64.

(5) SEBI Act should prevail.

2.47 MUTUAL FUNDS IN PRIVATE SECTOR :

Mutual Funds [MFs] were conceived as institutions for providing small investors with avenues of investment in the Capital Market. Small investors generally do not have adequate time, knowledge, experience and resources for directly accessing the capital market and as such they can rely on an investment intermediary with undertakes judicious investment decisions and provides the consequential benefit of professional expertise.

The Unit Trust of India [UTI] set up in 1964 under an Act of Parliament was the first mutual fund in India. During 1972-1987 seven new Mutual Funds were established in the Public Sector. A change in the Government Policy in 1993 led to the entry of Private Corporates and Foreign Institutional Investors etc., into the mutual fund segment taking the tally of Mutual Funds to 32 by the end of March 1997. Subsequently to the overall depressed conditions in the capital market, resource mobilization by Mutual Funds during 2002-03 declined mainly due to net outflow of funds from the UTI. Net resource mobilization by Mutual Funds is at the end of 2002-03 is as follows.

		2002-03		Amount in Rupees crore 2001-2002	
		No.of Schemes	Amount	No. of Schemes	Amount
1.	U.T.I	59	9434	72	7284
2.	Public Sector M.F	74	1968	69	1474
3.	Private Sector M.F	337	12,026	266	12947
	Total (1 to 3)	470	4580	407	7137

Source : RBI Annual Report

The subdued conditions in the Secondary Equity Market and buoyancy in the debt market enabled debt schemes to attract Funds in 2002-03 of the total asset. Under Management of Rs. 1,09,299 crore at end March 2003 (As against Rs. 1,00,954 crore at end March 2002) Net Assets under debt schemes accounted for 74.0 percent followed by nearly equi proportional shares of Equity and balanced schemes at 13.0 percent. The resource mobilization by Mutual Funds rose sharply during April, June 2003 to 19,432 crore as compared with an outflow of Rs. 832 crore during the corresponding period of the previous year.

Four key players are involved in the setting up of a Mutual Fund viz., a Sponsor, a Trustee, an Asset Management Company (AMC) and a custodian. Mutual Funds operate either open ended or close ended schemes which can be classified further as Income Scheme, growth scheme, Tax saving scheme etc.,

1. Close ended funds provide liquidity through listing on a recongnised Stock Exchange, more often through a repurchase option after a minimum lock-in-period.
2. Open ended Funds on the otherhand provide liquidity through the continuing facility of buy back and resale of their units.
3. Generally speaking such schemes are listed on the stock exchanges for dealings in the secondary market.

As to the Regulatory Framework the RBI had initially issued guidelines for Banks sponsored Mutual Funds in 1987 followed by guidelines laid down by the Ministry of Finance in 1991. Thereafter SEBI Securities and Exchange Board of India issued guidelines and a comprehensive set of Regulations relating to the Organization and Management of Mutual Funds.

Recently the SEBI has mooted a seperate Mutual Fund Act to protect the Interests of the Dave Committee on the collective Income schemes and P.K. KAUL Committee on the role of Mutual Fund Trustees are expected to submit their draft reports.

Increase in the number of Mutual Funds and the types of schemes offered by them to the Investors resulted in infusion of competition in this Industry. It was considered necessary that all mutual funds follow uniform norms for valuation of investments and accounting practices so that the Investors could Judge their performance on a comparable basis. In persuance of these recommendations SEBI issued new mutual fund regulations which provide for a short scheme wise Report and Justification and performance disclosure of large investments which constitute a significant portion of the portfolio and disclosure of the movements in this unit capital.

An important feature of the Mutual Fund Industry in India is the Tax shelter. A mutual fund set up by a Public Sector Bank or Financial Institution or that authorised by SEBI is exempted from Tax under Sec. 10 (23D) provided it distributes 90 percent of its profits. The specialised status enjoyed by the Mutual Funds Industry in terms of Fiscal incentives is one of the stimuli for its growth.

MONEY MARKET MUTUAL FUNDS :-

A recent development in the field of mutual funds is the emergence of Money Market Mutual Funds. The guidelines to establish MMFS were announced by the RBI for the first time in April 1992. Under the guidelines Scheduled Commercial Banks and Public Sector Financial Institutions are allowed to set up MMMF subject to prescriptions on funds Corpus and Investment patterns. Thus Mutual Fund Industry is catering to the needs of small investors and those who have no required knowledge in investments.

The RBI while initiating the Reforms Process in the country felt the necessity of strengthening the money market and appointed a Task Force to examine indirect participation of individual investors in the money market through MMFs. The RBI had twin objectives behind inviting the household sector. Firstly to provide depths, stability and maturity to the money market and secondly to increase returns on Investments of individual investors.

On the basis of the recommendations made by the Task Force, MMFs scheme was introduced in April 1992. Initially only mutual funds floated by Insurance Companies, Public Financial Institutions and Nationalised Banks were allowed to start MMMFs and RBI issued guidelines stipulating certain limits for investments by MMMFs. RBI has also permitted Private Sector Funds to set up MMMFs.

In order to make the MMMFs more attractive to Non Resident Indians (NRI's), the RBI has permitted repatriation of dividend and Income on these subscriptions. The principal amount of the subscription continues to remain non repritriable. There is minimum lock in period of 15 days which means that an investor cannot exist of the MMMF within 15 days of making his Investment.

Public Sector Mutual Funds required prior authorisation of only the RBI and the Private Sector Mutual Fund needs to approach the RBI as well as SEBI to setup MMMFs.

MMMFs which invest exclusively in various money market instruments like treasury bills, dated government securities with an unexpired maturity of upto one year call and notice money, Commercial Paper(CPs) and Certificate of Deposit can how determine the extent of their investment in Individual Investments except in the case of CPs where RBI has kept a limit on a MMMFs exposure to CPs issued by a company to three per cent of the total corpus. Allowing corporates to invest also added to the optimism.

Kothari Pioneer Mutual Fund was the first to launch a money market scheme and now many MFs offer Money Market Schemes.

In its credit policy of April 1999 RBI has allowed Banks to offer cheque writing facility for the investors of Money Market Mutual Funds (MMMF).

It should be in the nature of drawing account and no deposits can be made in the account. It should be clearly specify the drawal limit and the number of cheques that can be drawn as prescribed by the MMMF.

RBI has said that as MMMFs are non Banks and cannot provide “Cheque Writing” facility directly. The facility has to be in the Nature of a Tie-up arrangement with a Bank.

DEPOSITORY SYSTEM IN INDIA

Objective :

The students would get acquainted with full details of the Depository System. Which is a new concept in the Indian context. In order to understand property knowledge about Depository System is a pre-requisite. After going through this lesson students will get detailed Information about the need, importance, features, pros and cons of depository system.

STRUCTURE :

2.48 Introduction
2.49 Era of Scripless And Paperless Trading
2.50 Depository System - Objectives
2.51 Depository Act 1956
2.52 Features of Depository System
2.53 Dematerialisation of Shares
2.54 Procedure of Dematerialisation
2.55 Dematerialisation
2.56 Limitations of Dematerialisation
2.57 Stock Lending
2.58 Approved Intermediaries
2.59 National Securities Depository Ltd.,
2.59.1 Objectives
2.60 Services of NSDL
2.61 Central Depository and Securities (India) Limited (CDSIL)
2.62 Multiple Depository System

2.48 INTRODUCTION :

The Indian Capital Market witnessed an explosive growth between mid eighties and mid nineties. The total number of companies listed in the Stock Exchanges had grown by 72.3% from
The market capitalization of the companies
There are over 8,800 listed companies. 40 lakh Shareholders and 6,000 Stock Brokers and 24 Stock Exchanges is second in size only to that of USA. The Secondary Market Trading activity also gaining ground. There has been tremendous growth in Secondary Market Trading at BSE and NSE. Other regional exchanges like Calcutta, New Delhi have also become active players in the market.

2.49 ERA OF SCRIPLESS AND PAPERLESS TRADING :

In order to gain the Investor's confidence in the Stock Market the depository system was set up. It was against this background that the Government of India enacted the Depositories Act in 1996 which introduced an era of Scripless Trading and settlement efficient market Infrastructure, Investor Protection, reduced risks and Transparency of Transaction in the Securities Market.

2.50 DEPOSITORY SYSTEM - OBJECTIVES :

Soon after the enactment of the Depositories Act in 1996, the Financial Institutions at the Initiative of IDBI floated the First Depository, which is known as the National Securities Depository Ltd., The main objectives of the Depository are :

a) Eliminating paper work
b) Removing delays in settlement
c) Providing efficient service at low cost
d) Ensuring safe and secured transactions
e) Improving liquidity etc.,

The Government of India has given a further thrust by proposing to abolish the Stamp duty on Transfers of debt instruments in dematerialised mode. All these steps are bound to give a boost to the spread of Demat culture across the length and breadth of the country.

2.51 DEPOSITORY ACT 1956 :

The concept of Depository is known to the world since 1949 when the first depository was set up in Germany. There were only 32 depositories in the world in 1990, whereas 112 depositories are in operation by the year 2001. Every depository operates under a country's specific law and Regulation inorder to ensure safety, liquidity, rights and liabilities to the security holders.

2.52 FEATURES OF DEPOSITORY SYSTEM :

A Depository is an organisation where share certificates of a shareholder are held in the Electronic form. This is done at the request of the share holder through Depository Participant (DP). A DP is an interactive representative of both the Depository and the Investor. In otherwords, DP is a liaison between the Depository and the Investors. A DP maintains the securities account balances and intimates the status of holdings to the account bearers from time to time. According to SEBI guidelines, Financial Institutions, Banks, Custodians, Stock Brokers can become DPs. Investors intending to use the services offered by a depository have to open an account with the Depository through a DP which can be well compared with the Act of opening an account in a Bank Branch Office. A Depository is similar to a Bank in many respects.

2.53 DEMATERIALISATION OF SHARES :

Dematerialisation which is a euphemism for shredding, is a process by which an investor's physical share certificates are collected back by the Company/Registrar and destroyed. Then an equivalent number of securities are credited in the Electronic holdings of that Investor.

Till the Depository System was introduced two to three months time was taken to get the shares registered in the Buyer's name. Further, there was frequent chances of shares being lost or stolen during transit. But in the new system of Depository, when shares which are already in the Depository mode are purchased, the buyer becomes the owner of those shares within a day of the completion of the settlement. The advantage in this is elimination of Paper work in applying to the company to register the shares in Buyer's name. The possibility of loss or theft when certificates are posted to the company is eliminated.

Just like a Bank the DP also gives the Demat shareholders a Pass Book or Statement of holdings. The Statement of holdings will be dispatched periodically by the DP. However, the statement of holdings are sent whenever there is specific request from a Demat account holder. When a company announces rights issue or bonus Issue or cash dividend the depository will give all the details of clients having Electronic holdings of that security as per the record date or as on the date of book closure to the Registrar. The Registrar will then calculate and send the corporate benefits due to all such shareholders which are automatically credited in the accounts of the Demat shareholders.

The disbursement of benefits such as dividend/Interest will be done by the Registrar whereas the Depository will do the distribution of securities entitlements.

2.54 PROCEDURE FOR DEMATERIALISATION :

1) Surrendering certificates for dematerialisation to the Depository Participant
2) Submitting the certificates to the Registrar by the Depository participant
3) Confirming the dematerialisation request from NSDL by the Registrar.
4) Updating Accounts and Introducing NSDL of the completion of dematerialisation by the Register.
5) Updating its accounts and Introducing the Investors by the Depository Participant.

The entire process of dematerialisation will have to be completed within 15 days.

2.55 DEMATERIALISATION :

This is the term used for converting Electronic holdings back into Physical Share Certificates. If the Demat Account holders wish to get back securities in the Physical form a request is sent to his DP. for the rematerialisation of the same. The DP will then forward the request to the depository after verifying the necessary security balances. The Depository will in turn intimate the Registrar who will print the certificates and despatch them to the account holders.

PROCEDURE FOR REMATERIALISATION :

1) Request by the beneficial owner for Rematerialisation.
2) Intimation by the DP to the NSDL of the request through the system.
3) Confirmation by the NSDL of the rematerialisation request to the Registrar.
4) Updating of Accounts and Printing of Certificates by the Registar.
5) Updating of Accounts and downloading of details by the NSDL, to the Depository participant.
6) Dispatch of certificates by the Registar to the Investor.

2.56 LIMITATIONS OF DEMATERIALISATION :

There are certain constraints and deficiencies in the dematted and scripless mode of Stock Trading which are procedures related, paper related and person related.

1) At the outset in the Demat Account holding by the Investors, the DPs act on the Instructions given in the form of issue slips which are signed by the account holders. This signature must be matched with that in their data bank. Any small deviation in the pattern of signature leads to mismatch resulting in consequential loss of time and money. But this is not insisted forgery problems continue to haurt the Investors.

2) As long as share holding order in demat form is not made compulsory, there will be large number of shareholders who would like to hold shares in physical form. There is a possibility of Fake certificates in the Market. Unless the Registrar of companies is very alert there are possibilities of some cancelled shares being presented to the company for dematerialisation. In the absence of proper checks and controls these may get demated.

3) Person related Limitations : Payment of demat and remat charges is yet another deterrent to opt for dematerialisation. A demat account holder has to pay holding charges and if one wants to

get these converted in scrip form is required to pay rematerialisation charges to the company. The Investor is likely to lose both wap because he is not required to pay anything when the shares are bought and held in a scrip form. If the Investor continues to maintain the account, for long without many transactions any person knowing his account number may forge his signature and sell away his shares without the knowledge of the account holder.

2.57 STOCK LENDING :

In securities lending, the Legal title of a security is temporarily transferred from a lender to a borrower. The Lender retains all the benefits of ownership, other than the Voting Rights. The borrower is entitled to utilise the securities as required but is liable to the lender for all benefits (dividends, Interest or rights).

Securities lending began as a means to cover short sales (selling shares without possessing them) but has since evolved as a means of facilitating sophisticated trading strategies. Securities lending occurs when a holder of securities or his agent lends eligible securities to borrowers in return for a fee.

The absence of a formal market for securities lending had been felt for a while. Responding to market needs, SEBI introduced a scheme for securities lending and borrowing in 1997.

A Securities Lending Programme is used by the lenders to maximise yields on their portfolio. Borrowers use the securities lending programme to avoid settlement failures. Securities lending provides income opportunities for securities holders and creates liquidity to facilitate Trading Strategies for borrowers. Securities Lending is particularly attractive for large Institutional holders of securities as it is an easy way of generating income to offset custody fees and requires little, if any of their involvement or time securities lending gives borrowers access to lender portfolios which provide the flexibility necessary when borrowing for strategic positioning and financing inventories.

2.58 APPROVED INTERMEDIARIES :

At Present four entities have been registered with SEBI as approved Intermediaries (1) National Securities clearing corporation Ltd., (NSCCL) (2) Stock holding corporation of India Ltd., (3) DEUTSCHE Bank (4) RELIANCE CAPITAL. NSCCL proposes to offer a number of schemes including the Automated Lending & Borrowing Mechanism (ALBM), automatic borrowing for settlement failures and case by case borrowing.

Clearing and Trading members of Stock exchanges, Corporates, Financial Instructions and Foreign Institutional Investors, Mutual Funds, Banks and Individuals. Depending upon the constituent's own internal statutory guidelines and the eligibility criteria set by the approved intermediary for different schemes, these entities may act as lenders, borrowers or both.

2.59 NATIONAL SECURITIES DEPOSITORY LTD (NSDL) :

The NSDL is a Depository organisation promoted by three major Financial Institutions - (1) Unit Trust of India (2) Industrial Development Bank of India and (3) National Stock Exchange of India Limited NSDL has embarked upon a major promotional exercise in a big to spread awareness about Depositories and their Functioning.

2.59.1 OBJECTIVES :

NSDL has been established with a view to provide holding of securities in the Electronic form and settlement of trades for these Electronic holdings. As required by the Act, NSDL is responsible to every Individual Investor who holds electronic balances with the Depository. The Depository participants who register with NSDL act as its agents in providing its services to the Investors.

Under the Depository Framework of settlement, the NSDL does not move the securities from the delivering numbers to the receiving numbers until the clearing corporation confirms that all funds have been received. The clearing corporation required to ensure that no participant, at any time, either receives funds without delivering securities or receives securities without having paid funds.

2.60 SERVICES OF NSDL :

1) It maintains beneficial holdings through Depository participants. In otherwords, it acts through its participants in maintaining account balances of portfolio of securities belonging to the Individual Investors.
2) It provides both dematerialisation and rematerialisation facilities.
3) It affects account transfers for Settlement of Trades.
4) It allows for receipt of allotment in the Electronic form.
5) It provides pledging/hypothecation facilities for stocks held with it.
6) It provides stock Lending and Borrowing.
7) It receives and disburses Corporate Accounts pertaining to security holdings.
8) It credits entitlements of securities arising out of say bonuses or rights of the shareholders whose original holdings are in the Electronic form and intimates through its DPs of the securities entitlements.

2.61 CENTRAL DEPOSITORY AND SECURITIES (INDIA) LTD., (CDSIL) :

The Second Depository of the country was set up in 1999. The question of multiple depositories has arisen when the Mumbai Stock Exchange (BSE) announced setting up of a Depository of its own. While NSDL is the Depository set up by the National Stock Exchange (NSE) CDSIL is the Depository set up by the Mumbai Stock Exchange and Bank of India.

(CDSIL) got the certificate of commercement on 8, February 1999 and commenced limited operation of opening accounts and processing Demat request from March 22, 1999.

CDSIL and NSDL are established after several sounds of discussions on Technical and Administrative matters connectively with each other is established from September 20, 1999. This is a pre-requisite for any Inter Depository Transfer of Securities.

2.62 MULTIPURPOSE DEPOSITORY SYSTEM :

Some experts of a multiple Depository system hold a view that Monopoly in any service sector is underisable and that the greatest advantage of good service at cheapest rates is possible only with healthy competition and unless NSDL has a competitor it does not perform to the expected levels. The very purpose of Depository Act is to make the Indian Capital Market more efficient, transparent, Investor Friendly, reliable and secure. The benefits of competition between the two depositories are already witnessed by the Indian Capital Market in the form of reduced custody charges and reduced settlement charges. The Indian Capital Market is large with more than 8800 companies listed out of which 2000 scripts are actively traded. Number of Investors is estimated to be 25 million. The Market

capitalisation of equity and debt is estimated at Rs. 5,00,000 crores and Rs. 10,00,000 crores. This is more than one and half times the Bank deposits which are serviced by over 65,000 Bank Branches.

Such a large Market cannot be served by a single depository. Through a centralised depository system is in vogue in the developed countries which is functioning efficiently since over three decades. India by virtue of its huge volume of trade needs deserves Multiple Depository System. In our country household savings account for the largest segment of the country's savings and an access to the market is essential for the individual Investors who are spread over length and breadth of the country.

One more advantage of multiple depository system is that it provides a competitive spirit which helps in improvement of efficiency and quality of service. Absence of competition can harm the very purpose of reform for which Depository Act came into existence.

The Depositories Act and Regulation takes care of the compatible rules and practices among different depositories by emphasising the need for connectivity between several depositories between depositories and Issuers and as such there is a bright future to Multiple Depository System.

2.63 KEY WORDS :

CAPITAL MARKET :

Capital Market of a country is the barometer of that country's economy and provides a mechanism for capital formation. Business firms use capital market for raising long-term funds to take up their capital budgeting proposals.

RESIDUAL CLAIM ON ASSETS :

The Equity shareholders have a last or residual claim on the assets of the company in times of liquidation. In other words, they are paid whatever is left after all other liabilities of the firm are cleared.

PRE-EMPTIVE RIGHT :

The right of the shareholders to subscribe to issue of additional shares before these are offered to public.

SFC : State Financial Corporation
IIBI : Industrial Investment Bank of India
SIDBI : Small Industries Development Bank of India
IDBI : Industrial Development Bank of India
ICICI : Industrial Credit and Investment Corporation of India
Merchant Banking : Activities relating to corporate Finance, Public Issue, Project Finance, Mergers and acquisitions etc., under taken by Merchant Banker

STOCK EXCHANGE :

Any body of Individuals whether incorporated or not constituted for the purpose of regulating or controlling the business of buying, selling or dealing in securities is called a Stock Exchange.

SCR ACT 1956 :

The Securities Contracts (Regulation) Act is formed in 1956 with the main objective of controlling and regulating the activities of Stock Exchanges in India.

ON LINE TRADING :

Using the Net as a medium for communicating client orders to the Stock Exchanges through broker web sites is called On line Stock Trading.

ORDER ROUTING SYSTEM :

Using the Internet as a route for client orders to the Stock Exchanges through a registered broker on behalf of clients for execution of trades is called Order Routing System.

DERIVATIVES :

When Investors trade in Instruments derived from the cash market, where buyers take delivery on payment of cash is called Derivatives. Such Instruments in futures and options allow Investors to hedge their risk or even take speculative positions.

FUTURES :

It is an agreement between a buyer and seller for the purchase and the sale of a particular asset at a specific Future date. The asset in the case of Index Futures is an Index. It could be the S & P CNX NIFTY Index or BSE 30 SENSEX.

MUTUAL FUND : Mobilization of funds by organizations in public sector and private sector for purposes of investment in Stock Market Securities so as to give adequate return to the investors who cannot invest directly.

AMC : ASSET MANAGEMENT COMPANY.

MMMF : Money Market Mutual Funds.

UTI : UNIT TRUST OF INDIA.

DEPOSITORY : A Depository is an organization where share certificates of a share holder are held in Electronic form.

DEPOSITORY PARTICIPANT : Depository participant is an interactive representative of both Depository and the Investor.

DEMATEIRALISATION OF SHARE : Dematerialisation is a process by which an Investor’s physical share certificates are collected back by the company/ Registrar and destroyed.

DEMATERIALISATION OF SHARES : Rematerialisation is the term used for converting Electronic holdings back into physical share certificates.

STOCK LENDING : Stock Lending is a process in which securities are lent and the legal title of securities is temporarily transferred from a lender to a borrower.

1.2.10 SELF-ASSESSMENT QUESTIONS :

1. What is a capital Market? Explain its Functions and Instruments?
2. Explain the Advantages and Disadvantages of Equity shares in comparision with the Debentures?
3. Do you think Debentures are better than Preference shares?
4. Describe different types of Debentures?
5. Explain about the activities of IDBI.
6. Discuss the role played by SIDBI in Promotion of Small Industries.
7. Explain how the Industrial Investment Bank of India helps in reviving of companies.
8. Discuss the activities of EXIM Bank.
9. List out the activities undertaken by Merchant Banker and explain two of them briefly?
10. Explain the recent developments in the Merchant Banking.
11. Explain the activities of Investment Companies in India.
12. Explain the meaning and functions of development banks.
13. What are the social objectives of development banks?
14. Discuss the progress of development banks.
15. Define Mutual Funds and its activities ?
16. Explain about various categories of Mutual Funds ?
17. Explain the role of UTI in catering tothe needs of small investors ?
18. Discuss about (i) Money Market Mutual Funds (ii) Asset Management Companies.
19. What are the factors which lead to the setting up of Depository System in India ?
20. What are the main Features of Depository Act 1996 of India ?
21. Explain the procedure for Dematerialisation and Rematerialisation of shares?
22. What are the advantages and Disadvantages of Depository System?
23. What are the Functions of NSDL?
24. Do we require a Multi-Depository System in India?
25. How do operations on a Stock Exchange affect the Economic Life of a Nation ?
26. Out line the drawbacks and defects in the working of Stock Exchange in India ?
27. “The Stock Exchange is a legalised gambling den” - Comment
28. Explain the concept of Derivatives
29. What are the advantages and disadvantages of Online Trading ?

1.2.11 FURTHER READINGS :

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LESSON - 3

BANKING SYSTEMS

Objective :

After going through this lesson you are able to understand various Banking Systems such as Group Banking, Chain Banking, Unit Banking, Correspondent Banking and Mixed Banking and these systems role in the Indian Economy.

STRUCTURE :

3.1 Introduction
3.2 Group Banking and Chain Banking
3.3 Advantages of Group Banking
3.4 Disadvantages of Group Banking
3.5 Chain Banking
3.6 Introduction
3.7 Advantages of Unit Banking
3.8 Disadvantages of Unit Banking
3.9 Introduction
3.10 Features of Mixed Banking
3.11 Advantages of Mixed Banking
3.12 Disadvantages of Mixed Banking
3.13 Recent developments in the Banking System
3.14 Key Terms
3.15 Self - Assessment Questions
3.16 Further Readings

3.1 INTRODUCTION :

Different countries adopt different Banking Systems. Though the functions of banks are almost the same in every country, there are differences in the organisational set up and the lending practices of banks in different countries. Various types of Banking systems are (a) Branch Banking (b) Unit Banking (c) Group Banking (d) Chain Banking and (e) Mixed Banking. The secret of successful Banking is to distribute resources between the various forms of Assets in such a way as to get a sound balance between Liquidity and Profitability so that there is cash (on hand or quickly realisable) to meet every claim and at the same time enough income for the Bank to pay its way and earn profits for its shareholders.

3.2 GROUP BANKING :

This is that part of the system of Banking under which two or more banks are directly or indirectly controlled by an Association Trust or Corporation. This type of banking was very common in the U.S.A between 1925 and 1929. One group may comprise as many as 110 members. That was ofcourse the maximum number. A group could have a small number of member banks as well. Before the great depression of 1929 there were in the U.S.A. about 300 groups controlling more than 2000 bank branches. But during the great depression of 1929, several of these banking groups

failed and thereafter the importance of group banking as a system declined.

3.3 ADVANTAGES OF GROUP BANKING :

The system of Group Banking has several important advantages.

(1) Under this system every member bank retains its own seperate identity and maintains its own Board of Directors. The Central Administrative Office controlling the various members of the group and take steps to improve the level of efficiency in their day to day working.

(2) This system ensures liquidity of financial resources. If a member bank falls short of cash it can be easily transferred to it from the other member banks.

(3) This system also results in an economy in advertisement expenditure. The corporation controlling the member banks can insert joint advertisements in the news papers.

(4) Since the corporation controlling the member banks is a big sized corporation, it can easily obtain the services of the experts in the management of the business of the member banks. This helps the member banks to place their investments and banking business on sound footing.

(5) Under this system the stores of the various banks are purchased by a common purchasing organisation. This results in economy in purchases.

(6) The group management can also take steps to secure new business for its constituent units.

3.4 DISADVANTAGES OF GROUP BANKING :

The system of group banking also suffers from certain defects and drawbacks.

(1) If one member bank of the group fails due to the adoption of unsound policies it has its adverse repercussions on the other member banks.

(2) This system may not be conductive to the achievement, because the Central Administrative Office is generally not in a position to enforce codes of discipline on member banks.

(3) This system also gives rise to corruption because all the stores etc., for the member banks are purchased by one common purchasing organisation, which may succumb to pressures exerted by unscrupulous firms.

3.5 CHAIN BANKING :

This refers to that system in which two or more banks are owned and controlled by one person or a group of persons. This type of banking developed in the U.S.A. towards the middle of the last century but during the great depression of 1929 most of the Chain Banks met with failure. The most conspicious failure was that of Witham System operating in the states of Georgia and Florida comprising more than 175 branches. Chain Banking has certain important advantages among which may be mentioned fuller utilization of financial resources, better managerial services, higher profits, diversification of risks, economy in operational costs and centralized administrative control. This system of chain banking also suffers from certain defects among which may be mentioned, the lack of efficient management and supervision, the lack of flexibility, the undertaking of speculative activities by banks, the existence of corruption on the part of the officers and the employees of banks.

UNIT BANKING AND CORRESPONDENT BANKING

Objective :

After going through this lesson you will be able to understand Unit Banking its advantages and disadvantages.

STRUCTURE :

3.6 Introduction

3.7 Advantages of Unit Banking

3.8 Disadvantages of Unit Banking

3.6 INTRODUCTION :

Unit Banking is that system where an individual bank undertakes banking business either through a single office or through a few branches operating within limited area. The American Banks are overwhelmingly Unit Banks. They can be divided under two heads (1) National Banks and (2) State Banks. The former are established under Federal Laws while the latter are setup under the state laws. Some states in America do not allow their banks to open branches at all. While others allow their banks to open their branches only within the same city. The main reason for this adoption of Unit Banking System in the U.S.A. is the fear of emergence of monopoly in Banking. If there are small number of big banks having branches all over the country, there is every possibility of their coming together and forming huge monopolistic banking establishments which could undermine the Economic freedom of the people.

The unit banks in the U.S.A are linked with one another and with big Financial Centres in the country through the Agency of Correspondent Banks. The small unit banks deposit their surplus funds with the correspondent banks situated in nearby big cities. These correspondent banks tender their advice to the unit bank on various economic and financial problems. The correspondent banks provide remittance facilities to the unit banks and also give them loans in case of emergencies. Thus the Unit Banks in America have been linked with one another through the Agency of Correspondent Banks.

3.7 ADVANTAGES OF UNIT BANKING : Following are the main

1) **Convenience of management, supervision and control :** Since the size of the bank under unit banking is small, its management, supervision and control are easier and more convenient for the authorities. Along with this, the wastages here can also be controlled more effectively than under branch banking.

2) **Discontinuance of Ineffecient Branches :** As pointed out above, weak and non-profitable branches continue to be fed by strong and profitable branches under the system of branch banking. But this is not possible under unit banking. If a Bank is weak, in efficient and non-profitable, it will be automatically cease to exist after some time.

3) **Check on the formation of Monopolistic Banks :** Under Unit Banking the banks are generally of small size. There is almost complete absence of big sized banks under Unit banking. Hence there is no possibility of the growth of monopolistic banks under this system.

4) **No delay in Banking Business :** One great advantage of Unit banking is that there is no delay of any kind in taking decisions on important problems concerning the Unit bank. The reason is that the bank in question has not wait for directives from the Head Office. The local officers of the Unit Bank are competent to take decisions themselves on various problems confronting the Bank.

5) **Initiative in Business :** Since the Bank officers under the Unit Banking System are fully acquainted with the local problems they can show initiative in taking important decisions on the various issues confronting the bank. This makes the banking system more elastic than what is under the Branch Banking System.

6) **No Neglect of Local Requirements :** Since the Bank officers of a Unit Bank are fully acquainted with the local needs, they cannot neglect the requirements of local development. On the contrary, the requirements of local development are generally neglected under the system of branch banking.

3.8 DISADVANTAGES OF UNIT BANKING SYSTEM :

1) **Absence of Division of Labour and Specialisation :** Since the size of Unit bank is small and its financial resources are limited, it cannot make use of division of labour and specialisation on any worthwhile scale consequently, it is deprived on the advantages of division of labour and specialisation.

2) **No Geographical Distribution of Risks :** Under Branch Banking, business risks of the banks get automatically distributed over various areas and Industries in the country. The reason is that under this system, the banks have a large number of branches spread all over the country and they can invest their funds in different areas and in different busineses. This automatically results in the wide distribution of business risks. But under Unit banking, the Geographical distribution of business risks is not possible because the bank is located as one place only. Unlikely If that place suffers from business depression, then the bank incures heavy financial losses and there arises every possibility of its meeting with failure.

3) **Expensiveness and inconvenience in Remittance of Funds :** Since the Unit Bank has no branches at other places in the country, it has to depend upon the correspondent banks for effecting transfer of funds from one place to another. This makes the movement of funds more expensive and inconvenient for the businessmen.

4) **Inequality of Interest Rates :** Since there is no arrangement for the cheap remittance of funds under Unit banking system, there after arises inequality in the rates of interest in different parts of the country. For example, the interest rates are generally lower in big Commercial and Industrial Centres. They are rather high in the backward and undeveloped areas of the country. This hinders the Economic growth of backward and undeveloped areas of the country concerned.

5) **Little Development of Banking in Similar Towns and Cities :** Under Branch Banking, a big bank can open branches in the smaller towns and cities even though it may have to suffer losses in the process. But the unit banks are not in a position to open uneconomic branches

in the country because their financial resources are already limited and they cannot afford to open branches in similar smaller cities and towns.

6) **Absence of Efficiency in Banking Business :** Since the size of the Unit Bank is small it cannot afford to adopt the latest and most up-to-date methods of banking with the result that is efficiency generally is on the lowside.

7) **Inability to Face Crisis :** The Financial resources of a Unit bank are rather limited. Hence, it finds itself unable to face economic crisis. This was the reason why hundreds of unit banks failed in the U.S.A. during the great depression of 1929.

MIXED BANKING

Objective :

After going through this lesson you should understand the system of Mixed Banking, and recent developments in the Banking System and Universal Banking.

STRUCTURE :

3.9 Introduction
3.10 Features of Mixed Banking
3.11 Advantages of Mixed Banking
3.12 Disadvantages of Mixed Banking
3.13 Recent developments in the Banking System

3.9 INTRODUCTION :

Mixed Banking System is that system of banking under which the Commercial Banks make both short term as well as long term loans to commerce and industry. Under the mixed banking system, the banks finance long term requirements of industries, besides catering to the short term needs of commerce and trade.

3.10 FEATURES OF MIXED BANKING :

Commerce requires Short Term Loans. But it Industry requires not only short term but also long term loans. Under the mixed system of banking, the Commercial Banks meet both the short term and long term requirements of Industries. It is on this account that the system is known as the mixed system of Banking. The German Banking system presents the best example of mixed banking in the world. The German Banks unlike the British Banks are of the mixed type. Infact, the German Banks perform such a large variety of functions that they are very often referred to us as “UNIVERSAL BANKS”.

The development of mixed banking in Germany was also the result of historical reasons. Unlike in Britain the development of German Industry preceeded the development of Trade and Commerce. There were no established Financial Institutions in Germany which could Finance the development of Industries. So the Commercial Banks has to finance the long term requirements of

industries, besides catering to the short term needs of trade and commerce. The system of mixed banking is thus plays an important role in Banking sector.

3.11 ADVANTAGES OF MIXED BANKING :

1) The Industrial Units financed by the Banks have the advantage of receiving their expert guidance on various financial issues. The banks help the Industrial concerns in collecting larger financial resources by selling their stocks and shares to the public.
2) The Banks also benefit by acquiring a thorough knowledge of the working of the Industrial System of the country.
3) The provision of long term accommodation to the industries enables the banks to invest their surplus resources for industrial development.

3.12 DISADVANTAGES OF MIXED BANKING :

1) This system constitutes a series threat to the stability of banks. If the industries suffer losses due to depressed business, the profitability of the banks will also receive a setback because the banks shall not be able to recover their loans from the industries at a time of depression.
2) It is not banking practice to look up the banks to give loans and advances for short-periods only. The long term investments in Industries should be left to the specialized Industrial Investment Corporations in the country.

3.13 RECENT DEVELOPMENTS IN THE BANKING SYSTEM :

In the context of the decleration in the Economy the Intermediation role assumes even greater relevance. Banks and Financial Institutions should endeavour to play a “Supply-Leading” rather than demand following role in initiating the upturn by energising the Financial Intermediation Process. By virtue of bird’s eye view of the economy and their superior credit assessment of the investment proposals and the efficiency of capital, banks should endeavour to economise on ‘search’ costs in identifying and nurturing growth impulsed in the commodity and service producing sectors of the Economy.

In the recent period, monetary policy in India has also moved into a counter-cyclical stance signalled by cuts in key interest rates and cash reserve requirements. At the same time, market operations have ensured adequate liquidity to support the revival of aggregate demand with a clear preference for sofetening of interest rates within the overall institutional constraints on the interest rate regime. Inflation has been steadily falling and this has had a positive impact on inflation expectations along with the underlying resilience of the macro economic fundamentals on the Indian Economy. The 50 basis point reduction in the bank rate and the 200 basis point reduction in CRR, announced recently, are expected to significantly enhance the lendable resources in the Banking System.

The current situation of comfortable liquidity provides an opportunity for the banks to transform idle liquidity into investible resources of growth. The easy interest rate environment would make it

possible for banks to “Price in” projects which would have earlier remained unfunded due to inherently lower returns of capital or due to lack of access to prime lending rates. This will, however, require reassessment of portfolios and internal liquidity constraints, even adjustments in risk profiles and risk management.

PRUDENTIAL NORMS :

A strong and resilent financial system and the orderly evolution of Financial Markets are key prerequisites for financial stability and economic progress. In keeping with the vision of an internationally competitive and sound banking system, deepening and broadening of prudential norms to the best internationally recognised standards have been the core of our approach to financial sectors reforms. This has been supported concurrently by heightened market discipline, pro-active and comprehensive supervision of the Financial system and the orderly development of financial market segments. This calibration of the convergence with international standards is conditioned by the specific realities of situation. However, the New Capital Accord of the Basel Committee on Banking supervision which was released in Jan 2001 adds urgency to the process of convergence. It is against the backdrop of these exigencies that Prudential Norms are being constantly monitored and refined. In the recent period, banks are being encouraged to build risk-weighted components of their subsidiaries into their own Balance Sheets and to assign additional capital. Risk weights are being constantly refined to take into recognition additional sources of risk. The concept of “Past due” in the identification of NPAs has been dispensed with. Banks and Financial Institutions are being urged to prepare to move to the International practice of the “90 day norm” in the classification of assets as non performing by 2003-04.

The Basel accord, as contained in the second consultative paper on capital adequacy of the Basel Committee on Banking supervision released in January 2001 is in response to the perceived rigidities in the 1988 accords capital requirements, the scope for capital arbitrage and the increased sophistication in the management of risk. The new accord rests on three mutually reinforcing pillars i.e., minimum capital requirements, processes of supervisory review and market discipline. Under the first pillar, the current definition of capital and the minimum requirement of 8 percent of capital to risk weighted assets is retained.

BENCHMARKING THE INDIAN BANKING SYSTEM BY INTERNATIONAL STANDARDS

The impetus given to strengthening of domestic Financial Systems and the International Financial architecture by the Asian crisis has gathered momentum in recent years. An important development in this regard has been the move to setup universally acceptable standards and codes for Benchmarking domestic financial systems. Moreover multi-lateral assessments of country performance are increasingly focusing on observance of standards. The IMF’s article IV consultations, its Financial Sector stability assessment and the reports on observance of standards and codes of the IMF and the world Bank are indicative of the fact that a country’s adherence to benchmark standards and codes is being considered integral to the preservation of internationally monetary and financial stability. While the processs has begun with the predominant involvement of Governments and regulators, the search for the standards and codes is progressively encompassing the Private

Sector with consideration of issues relating to market discipline, corporate goverence, insolvancy procedures and credit rights.

It is important to recognise that now standards and codes are not being granted as Final goals but as instruments or enabling conditions for enhancing efficiency in financial intermediation while ensuring stability. There are three levels at which action is necessary viz., Legal, Policy and procedures and market practices by participants. In several areas, fundamental changes in the Legal and Institutional infrastructure are pre-requisites.

UNIVERSAL BANKING SYSTEM :

Since the early 1990's Banking Systems worldwide have been going through a rapid transformation mergers, amalgamations and acquisitions have been undertaken on a large scale in order to gain size and to focus more sharply on competitive strengths. This condition has produced financial carglomerates that are expected to maximize economies of scale and scope by "bundling" the production of financial services. The general trend has been towards downstream Universal banking where banks have undertaken traditionally non-banking activities such as Investment Banking, Insurance, mortgage financing, securitisation and particularly Insurance. Upstream linkages where non-banks undertake Banking Business are also on increase. The Global experience can be segregated into broadly three models. There is Swedish or Hong Kong type model in which the Banking Corporate engages in house activities associated with Banking. In Germany and the U.K certain types of activities are required to be carried out by seperate subsidiaries. In the U.S type model there is a holding company structure and seperately capitalised subsidiaries.

In India the first impulses for a more diversified Financial Intermediation were witnessed in the 1980's and 1990's when Banks were allowed to undertake Leasing, Investment Banking, Mutual Funds, Factoring, Hire-purchase activities through seperate subsidiaries. By the mid 1990's all restrictions on Project Financing were removed and Banks were allowed to undertake several activities in house. In the recent period, the Focus is on Development Financial Institutions (DFIs) which have been allowed to set up Banking subsidiaries and to enter the Insurance Business along with Banks. It was the NARASIMHAM COMMITTEE - II Report (1998) which suggested that the DFI's should convert themselves into banks or non-bank financial companies and this conversion was endorsed by the Khan working group (1998). The RBI's discussion paper (1999) and the feed back indicated the desirability of Universal Banking from the point of view of efficiency of resource use, but it also emphasized the need to take into account factors such as status of reforms, the state of preparedness of the Institutions and a viable transition path while moving in the desired direction.

Accordingly, the mid-term review of monetary and credit policy, October 1999 and the annual policy statements of April 2000 and April 2001 enuciated the broad approach to Universal Banking and the RBI's circular of April 2001 set out the operational and regulatory aspects of conversion of DFI's into Universal Banks. The need to proceed with planning and foresight is necessary for several reasons. The move toward Universal Banking would not provide a panacea for the endamic weakness of a DFI or its liquidity and solvency problems and/or operational difficulties arising from under capatalization, non-performing assets and asset liability mismatches etc., The over riding

consideration should be the objectives and strategic interests of the Financial Institution concerned in the context of meeting the varied needs of customers subject to Normal Prudential Norms applicable to banks. From the point of the Financial system, perserve the safety of public deposits, improve efficiency in Financial Intermediation, ensure healthy competition and impart transparent and equitable regulation.

3.14 KEY TERMS :

1) **Chain Banking :** It means the control and operation of three or more than three independently established banks by one or more persons. The control is generally exercised through stock ownership or interlocking directorates. But Chain Banking can also assume other forms. This type of Banking is current in the U.S.A.
2) **Group Banking :** This is a system of Banking under which two or more banks are directly or indirectly controlled by an association, trust or corporation.
3) **Pure Banking :** This is a system under which Commercial Banks confine themselves to the Financing of the short term requirements of Commerce and Industry.

3.15 SELF - ASSESSMENT QUESTIONS :

1) Discuss the relative merits and demerits of Unit Banking and Correspondent Banking
2) What is Mixed Banking? What are the advantages and disadvantages of mixed Banking?
3) Define Group Banking? What are the advantages of Group Banking?

3.16 FURTHER READINGS :

1. L.V. Chandler - The Economics of Money and Banking
2. R.S. Sayers - Modern Banking
3. M.L. Seth - Monetary Economics, Published by Lakshmi Narain Agarwal, Agra - 3.
4. Indian Banking and Finance - Managing New Challenges by Bimal Jalan Ex-RBI Governor on 14, January 2002 at Kolkatta (Speech).

Lesson - 4

DEVELOPMENT OF COMMERCIAL BANKS IN INDIA AND USA

OBJECTIVES :

The purpose of this lesson is to introduce to you the development of commercial banking network in India and USA. After you have studied this lesson you should be able to know :

- Banking setup during 1949-1969
- Nationalisation of banks in India
- Banking structure in India
- Banking developments in USA
- Restructuring of banks in India

STRUCTURE

4.1 Introduction
4.2 Banking developments during 1949-69
4.3 Nationalisation of banks
4.4 Rationale for nationalisation
4.5 Criticisms of privately owned commercial banks
4.6 Banking structure in India
4.7 The State Bank of India and its associate banks
4.8 Other nationalised banks
4.9 Regional rural banks
4.10 Other scheduled commercial banks
4.11 Foreign banks
4.12 Changing role of commercial banks in USA
4.13 Restructuring process in India
4.14 Questions
4.15 Further Readings

4.1 INTRODUCTION :

At the time of Independence Indian banking system was not sound. There were hundreds of small banks under unscrupulous managements. Hence, in 1949 two major actions were taken which were very important from the point of view of structural reforms in the banking sector. First, the Banking Regulation Act was passed. It gave extensive regulatory powers to Reserve Bank of India (RBI) over the commercial banks. Another development of no less importance was the nationalisation of the RBI. These two major developments in the immediate post-Independence period proved to be the turning points in India's commercial banking.

4.2 BANKING DEVELOPMENTS 1949 - 69 :

In the two decades following the enactment of the Banking Regulation Act, 1949, the Indian banking system developed in many respects. It not only grew geographically, but also structurally and

functionally. The number of scheduled banks, however, decreased from 94 to 76 over the period. A significant change that occurred in this period was a steady decline in the importance of the non-scheduled commercial banks. The Banking Regulation Act provided extensive regulatory powers to the RBI and with that it bacame possible for it to carry out various structural reforms in the banking system.

Judged on the basis of deposit mobilisation, commercial banks made considerable progress in this period. Deposits of the scheduled banks other than those of the State Bank f India and its associate banks increased from Rs. 843 crore in 1950 - 51 to Rs. 5,028 crore in 1969-70. The other notable features in deposit growth of the period were the higher rate of growth in time deposits relative to demand deposits and the rise in the number of personal accounts relative to business accounts.

The establishment of the State Bank of India in 1955 and the creation of the State Bank group by nationalising eight regional banks in 1960 allowed scope for a new experiment in the Indian banking. Under a statutory obligation these banks opened new offices in semi-urban and rural areas and approached those sections of people which were hither to never served by the modern banks. This attempt bore fruits and their relative share in total deposits received by the commercial banks increased. It was claimed by the bankers that the substantial rise in the bank deposits over the period reflected the growing banking habit in the country. P.R. Brahmananda, however, rejected this claim. He contented that a rise in the proportion of industrial output to national output and continuous rise in the prices of commodities were the two factors that explained the faster rate of growth of deposits vis-a-vis national income.

The period also witnessed a change in the lending policy of commercial banks. For long the major part of their credit had gone to commerce and large and medium-scale industries. During the period under reference not only the commercial bank credit to industries increased, the bank also developed in interest in term lending. Consequently industries accounted for 68 percent of the commercial bank credit in 1968 as against 34 percent in 1951, while commerce accounted for 19 percent of the commercial bank credit in 1968 as against 36 percent in 1951. As it happened in the past, agricultural and allied activities. Small-scale industries, and retail trade remained neglected and lending to them was negligible.

Finally, in or to provide some protection to the depositors, an important step in form of establishment of the Deposit Insurance Corporation was undertaken on January 1, 1962. The deposit insurance is very helpful in mobilisation of deposits, as it enhances confidence of people in banks. Its need was long felt in this country, particularly during the periods of large scale bank failures.

4.3 NATIONALISATION OF BANKS :

In a free enterprise economy, commercial banks operate like any other business and are mainly concerned with the maximisation of their private gains. Lacking any social purpose they often channelise funds to business units in which the management has its interest and thus contribute in a big way to growth of monopolies and concentration of economic and political power, while overall economic activity suffers because priority sectors / industries fail top get adequate funds. It was long felt that so much freedom to commercial banks was not in harmony with the concept of the

socialist pattern of society which had formally become the accepted goal of the Indian Society. The Hazari Committee, in its report on 'Industrial Planning and Licensing Policy' submitted to the Planning Commission on September 14, 1967, clearly underlined this point when it stated, "It would be difficult to undertake credit planning unless the linked control of industry and banks in the same hands is snapped by nationalisation of banks". The government, however, decided in favour of social control. For implementing the social control policy the government undertook two measures : 1) Establishment of National Credit Council as an advisory body; and 2) Enactment of the necessary banking legislation.

The social control phase, however, turned out to be transitory, Expectations of the government that the social control would remove objectionable banking practices of the past and would give a new sense of purpose to the banks for future were believed. Having realised that nothing short of nationalisation would solve the malady, the government took a bold decision to bring under its direct control a substantial segment of the banking system.

On July 19, 1969 fourteen commercial banks with deposits worth Rs. 50 crore or more were nationalised. This was hailed as a historic event by the people of the country. Some experts also supported it as a timely measure. Nonetheless, industrialists and some other vested interests condemned it by calling it a political gimmick. D.N. Ghosh viewed it in a larger perspective when he made the following observations : "The decision of July 1969 was a complete break from the tradition; it was an explicit recognition by the government that it could not absolve itself of its responsibilities of controlling directly the banking system if it was to be shaped as an instrument of furthering economic development in accordance with national objectives and priorities.

4.4 RATIONALE FOR NATIONALISATION :

In her broadcast address of July 19, 1969, on bank nationalisation, Prime Minister Mrs. Indira Gandhi stated that nationalisation was meant for an early realisation of the objectives of social control which were spelt out as. "(i) removal of control by a few, (ii) provision of adequate credit for agricultural and small industry and export (iii) giving a professional bent to management, (iv) encouragement of a new class of entrepreneurs, and (v) the provision of adequate training as well as terms of service for bank staff".

The case of nationalisation was much stronger than what was made out by the Prime Minister. Social control suffered from some inherent limitations and thus even if it was given a longer period of trial it would not have made significant difference. K.N. Raj has drawn pointed attention to the limitations of banking legislation in introducing soundness in banking practice. He has stated : "A comprehensive system of banking legislation and control which spells out in very precise terms the security on which loans are to be advanced by private commercial banks, the margins to be applied, the length of the loans, etc., is . . . not a very dependable way of introducing 'soundness' into commercial banking operations. By the rigidity they introduce, and the bias most such banking legislation and control display in favor of bank advance on the security of particular assets like commodity stocks, government securities and gold, they do not help to bring about what could be a more optimum allocation. As is now generally recognised, some of the potentially most productive loans that could be advanced in underdeveloped countries might be to small enterprises in agriculture and industry which have particularly none of the conventionally acceptable securities to offer. Nevertheless, the

bias of banking legislation and control has been usually in the direction of loans based on more conventional criteria, since to the extent that uncoventionality is permitted, banking legislation and control become more difficult to administer.

4.5 CRITICISMS OF PRIVATELY OWNED COMMERCIAL BANKS :

We shall now explain some more widely known criticisms of privately owned commercial banks. It is in fact these criticisms on the basis of which a strong case was made out for the nationalisation of banks.

1) PRIVATE OWNERSHIP OF COMMERCIAL BANKS AND ABUSE OF POWER BY THE DIRECTORS :

Control of big business houses over commercial banks invariably results in concentration of wealth and economic power. Until their nationalisation, all major banks in India were controlled by one business houses or the other or jointly by a few of them. The combined paid up capital of the banks was around Rs. 100 crore, whereas deposits received by them amounted to about Rs. 5,000 crore. The benefit of these massive financial resources had gone largely to the big business which controlled the banks. Both the Mahalanobis Committee on the distribution of National Income in India and the Vivian Bose Commission had clearly exposed the nexus between the banks and the big business houses and they used their positions to finance the companies in which they had interests. Sometimes to provide safeguards against the criticism of favoratism, they financed each other's companies on a reciprocal basis.

II) DENIAL OF CREDIT OF PRIORITY SECTORS :

Claims of agriculture for loans were always turned down in the past by the commercial banks on the plea that agricultural credit did not fall within their purview. Indifference of the commercial banks to agriculture in this country could be judged from the fact that in 1966-67 bank advances for agricultural operations amounted to Rs. 6 crore, a more 0.2 percent of the total advances in that year. Before their nationalisation, the lending policy of the commercial banks was highly discriminatory. Their anti-small borrower bias was obvious, and they generally ignored the claims highly discriminatory. Their anti-small borrower bias was obvious, and they generally ignored the claims of small industrialists in respect of credit. Commercial banks also violated the priorities laid down in the plans while granting loans to various industries. Many industries, which nowhere figured in the priority list got large funds, whereas the priority sectors starved for resources.

(III) CREDIT FOR SOCIALLY UNDESIRABLE ACTIVITIES :

Credit policy of the commercial banks until their nationalisation encouraged some socially undesirable activities, such as hoarding, black-marketing, etc., Anti-people elements like hoarders and black marketers borrowed heavily from the banks to corner the supplies of essential commodities, including foodgrains. The Reserve Bank resorted to selective controls to put an end to these activities, but the success achieved was not much. The commercial banks refused to extend necessary cooperation and often taking advantage of the loopholes in statutory provisions acted contrary to the spirit of controls. Only nationalisation of banks could thus change the approach of commercial banks in this regard.

(IV) ABSENCE OF BALANCED BANKING DEVELOPMENT :

Prior to their nationalisation, commercial banks has shown virtually no interest in establishing offices in semi-urban and rural areas. More and more branches were set up in cities by different banks resulting in concentration of banking facilities and unwarranted competition between them. Commercial banks' lack of interest in opening branches in the countryside was primarily due to lack of profitability. Nationalisation of commercial banks was the only answer to this problem, because of public sector bank could always be expected to subordinate the private profitability objective to resource mobilisation objective in the larger interests of the society.

The government, however, refrained from making criticism of the private ownership of commercial banks. The explanatory statement on bank nationalisation in the Parliament emphasised the role of the nationalised banks as a catalytic agent for growth. One would easily note a greater precision in the statement of objectives and reasons accompanying the Banking Companies Acquisition and Transfer of Undertakings Act.

"The banking system touches the lives of millions and has to be inspired by larger social purpose and has to subserve national priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising of employment levels encouragement of new entrepreneurs and the development of the backward areas. For this purposes it is necessary for government to take direct responsibility for the extension and diversification of banking services and for the working of substantial part of the banking system".

This and some other subsequent official pronoucements lacked specificity in operational terms. Nevertheless, the two main objectives for public sector banks were spelt out. They were mobilisation of deposits through a massive programme of branch expansion particularly in the unbanked rural areas, and ensuring adequate financial assistance to the priority sectors of the economy.

4.6 BANKING STRUCTURE IN INDIA :

The commercial banking system in India now consists of public sector scheduled banks and private sector scheduled as well as non-scheduled banks. In terms of business the public sector banks now have a dominant position. They now account for more than 80 percent of the entire banking business. Amongst the public sector banks the State Bank of India and associates had 13,306 branches as on June 30, 2000. The number of branches were increased to 13,499 as on 30th June 2000. The nineteen nationalised banks had 32,504 offices all over the country ason June 30th 2003 increased to 32,643 at the end of June, 2003. In recent years in order to meet the credit requirements of the weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs, the regional rural banks have been set up in different parts of the country. Their number was 196 on June 30, 2003 and their branches numbered 14,522. In terms of business they, however, remain very much less important than the traditional commercial banks. The foreign scheduled banks operate mostly in big cities and their number of branches in the whole country is Just 204. Other scheduled commercial banks are private sector banks and their branches numbered 4,995 as on June 30, 2000. Their number is increased to 5624 as on 30th June, 2003. As a whole, India now has a far more developed and integrated banking system than that at the time of Independence. However, in a highly regulated system not only the service of customers, both as

depositors and borrowers, has suffered but many irregularities also developed in the banking system which surfaced in 1992. Under financial sector reforms now an attempt is being made to overcome these weaknesses of the banking system. To give a fuller view of the existing banking structure we shall briefly analyse its various constituents.

4.7 THE STATE BANK OF INDIA AND ITS ASSOCIATE BANKS :

On the recommendation of the Rural Credit Survey Committee the Imperial Bank of India was converted into the State Bank of India on July 1, 1955. Its 92 percent shares were acquired by the RBI, and that it had the distinction of becoming the first State Bank of India the main consideration was that to the countryside even if initially it was not a commercially viable proposition. In view of this necessity the State Bank was required to function as a development agency besides performing the traditional functions of a commercial bank. It was made a statutory obligation that it would open at least 400 branches within five years from the date of its establishment. Most of these branches were to be set up at unbanked centres. In course of time this initiative of the State Bank induced other commercial banks performed in the country, the State Bank was entrused with the task of the RBI's agent. In this capacity it now receives and makes payments on behalf of the Central and State Governments.

In 1959 the State Bank of India (Associate Banks) Act was passed and this paved the way for creating the State Bank Group. Now State Bank of Hyderabad, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra and State Bank of Travancore constitute the State Bank Group.

Though the State Bank of India was established as a commercial bank, but with its efforts a new era of mixed banking system ushered in the country. Financing to agriculture and other priority sectors could also be a viable commercial activity was proved by the experience of the State Bank of India. This in fact had weighed considerably when the decision to nationalise fourteen commercial banks was taken in 1969. Over the years the State Bank of India has expanded its business in a big way. When it was set up in 1955, it had got 466 branches from the Imperial Bank. The State Bank Group comprising the State Bank of India and 7 associates has expanded the number of branches from 2,462 on June 30, 1969 to 13,306 on June 30, 2000. The total number of branches further increased to 13,749 as on 30th June 2003. The State Bank of India and its associate banks thus together accounted for around 20 percent of the total branches of all commercial banks in the country. The share of the banking business with them was also roughly 29 percent. These facts today bear the testimony to their importance in the country's banking structure. In 1993 the State Bank of India Act was amended to enable it to have access to the capital market. The State Bank of India thus raised over Rs. 2,400 crore through public issue. The RBI shareholdering is now 67 percent as against 99 percent earlier.

4.8 OTHER NATIONALISED BANKS :

A second category of public sector banks is of nineteen commercial banks, of which fourteen were nationalised on July 19, 1969. Each one of these fourteen banks had deposits of Rs. 50 crore or more. This step, though not unprecedented in the history of Indian banking, had changed the very complexion of the banking structure in the country. The nationalisation was justified by the government

on the ground that the major banks could not be any more allowed to remain captive organisation of the big business. Their policies should be inspired by the larger social purpose and be in accordance with the national priorities and objectives. Hence, a fundamental shift in their approach was witnessed in the post-nationalisation phase. The banking system in this period became an instrument of development. The Lead Bank Scheme formulated in December 1969 played a significant role in transforming these profit maximising institutions of yester years into catalysts of local development. After nationalisation of 14 banks, there was rapid expansion of branch net-work. On April 15, 1980 six more private owned commercial banks were nationalised. The purpose, as it has been stated by the government, was "to control the heights of the economy, to meet progressively and service better the needs of the development of the economy and to promote welfare of the people, in conformity with the policy of the State". With the nationalisation of six more banks, the share of private sector in the entire banking declined to just 9 percent. In 1993, New Bank of India merged with Pubjab National Bank. As a result the number of public sector banks other than the State Bank of India and its associates declined to nineteen. The total number of branches of the nineteen nationalised banks was 32,504 as on June 30, 2000 increased to 32,643 as on June 30th 2003.

4.9 REGIONAL RURAL BANKS :

The nationalisation of major fourteen banks though successful in many respects failed to solve all problems of finance. For example, the nationalised banks could not do much to solve the problem of rural indebtedness. The grip of moneylenders remained tight in the countryside and rural indebtedness was widespread. Therefore, a new type of banking institution called Regional Rural Banks was conceived. The Working Group on Rural Banks (Chairman : M. Narasimham) recommended the setting up these banks as part of a multi-agency approach to rural credit. These banks have been set up under an Act of 1976. A regional rural bank is sponsored by a public sector bank which also subscribes to its share capital. Assistance is also given in the form of managerial personnel. The regional rural banks, though operating as a subsidiary of one or the other public sector bank, in terms of ownership are predominantly government undertakings. The regional rural banks meet the credit requirements of weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs. As on June 30, 2000, there were 196 regional rural banks with a network of 14,459 branches in the country. The total number of branches were increased to 14,522 as on June 30, 2003, of which 12,050 were in rural areas, 2078 were in semi-urban areas. Ninety percent of these have been opened in rural areas and unbanked centres. Since regional rural bank was an innovation, its viability was in doubt. As such, a study was conducted by the RBI. The study concluded that "on an average regional rural bank would require about six years and a network of 70 branches to become viable. For this it is necessary that it reaches an outstanding loan business level Rs. 8 crore and also has a margin of about 5 percent between its borrowing and lending rates". Over the years regional rural banks have accumulated massive losses and the recovery of loans position of these banks is bad.

4.10 OTHER SCHEDULED COMMERCIAL BANKS :

Now relatively small scheduled commercial banks and ten newly established banks with a network of 5,624 branches are operating in the private sector. In terms of branches and also the

business done by them, private sector banks are much smaller than both nationalised banks and foreign banks and thus their role in the financial system of the country is just marginal. A comparative study of the fourteen nationalised banks and thirteen selected private sector banks by the Economic Research Division of the Birla Institute of Scientific Research has revealed some interesting facts. The study covering a period of 11 years since the nationalisation of 14 banks has found that the branch expansion was unprecedented throughout. But more significant fact is that the average rate of branch expansion was generally higher in the private sector (18.7 percent) than in the nationalised sector (14.6 percent). The deposits for the new branches, however, was generally higher in the case of the nationalised banks than in the private sector banks. This was mainly due to the fact that the depositors had less confidence in smaller banks, and given the choice they would always prefer a bigger nationalised bank to a smaller private bank. The level of advances per new branch in the two sectors indicated a mixed trend. Recently having realised that over the years competitive efficiency has suffered in the banking sector, setting up of new private sector banks is being encouraged. So far ten new private sector banks have been set up and, in principle, three more proposals for setting up banks in the private sector has been approved. These private sector banks (both old and new) accounted for 13.1 percent of the bank deposits in 1999 - 2000. Their share in aggregate advances was also low at 12.6 percent.

4.11 FOREIGN BANKS :

On June 30, 2000, the country had 42 foreign banks with 186 branches located mainly in big cities. Except a few which have opened their offices in India recently majority of these banks have been operating in this country for a long time. Their standing, in fact, in the country is even longer than that of most of the leading scheduled banks of this country. Apart from financing of foreign trade, these banks had made significant contribution to the development of banking habits in the country as they have performed all the functions of the commercial banks, including the acceptance of deposits and lending of funds for trade and commerce. In financing the foreign trade, foreign banks had virtual monopoly till recently. Since Independence some leading commercial bank have set up their offices in foreign countries. Initially these banks met with serious difficulties, as they were discriminated against by foreign firms. Lately, the position has started changing and the financing of foreign trade is no longer an exclusive preserve of the foreign banks. Nonetheless, the foreign banks still have an advantage over the Indian Banks because of the early begining they had made in this area. Furthermore, their resources are vast and the management is superior.

Foreign banks as a group have generally been a suspect in this country because of their practices. Until the Banking Regulation Act was passed in 1949, their business activities were a guarded secret. As the audit of their business in India was not required and they had no statutory obligation to publish their balance sheet, the RBI had absolutely no control over them. Their unfair competition with the Indian Banks, and practice of financing India's foreign trade by drawing short term funds from the London money market were the major irritants in the past. With the growing strength of the Indian banks and development of adequate regulatory systems the foreign banks have improved their practices and have stopped pursuing discriminatory policies. However, in recent years certain foreign banks have committed gross irregularities and have been a major factor in the securities scam. The foreign banks in India are, operating with 204 branches as on 30th June 2003.

4.12 CHANGING ROLE OF COMMERCIAL BANKS IN USA :

The US banking industry has changed dramatically since 1980. Large corporates no longer look at commercial banks for loans and even if such loans are granted, they are not profitable in view of competition in the market and the availability of alternate avenues to raise funds. During the last three decades the industry dynamics have changed.

The number of banking organisations declined from 14,407 in 1980 to 14,381 in 1984. From 1986 onwards, there has been a steady decline of about 400 - 500 banks each year. By the end of 1998, the number of bank mergers showed a steadily increasing trend, increasing from 190 in 1980 to a peak of 649 in 1987 and stood at 518 in 1998. The period 1985 to 1992 witnessed around 100 to 200 bank failures each year, which there after tapered down to 1 in 1997 and 3 in 1998. The merger activity has changed the overall structure of the US banking industry.

Inspite of the above developments and trends, the number of bank offices showed a persistent increase from 52,710 in 1980 to 63,392 in 1990 and to 71,231 in 1998. The expansion of the branch network was associated with a decline in the number of people served by a bank office from 4,311 in 1980 to 3,935 in 1990 and 3,795 in 1998.

As ATMs started proliferating the US landscape, the brick and mortar banking was expected to decline. But this has not happen. The of ATMs increased tremendously from 18,500 in 1980 to 1,87,000 in 1998. The number of ATM transactions increased from nearly 1 billion in 1980 (54,000 transactions per ATM) to 11.2 billion in 1998 (60,000 transactions per ATM).

From the profitability angle, the average return on assets declined from 1.18 percent in 1980 to 0.40 percent in 1986 and thereafter showed steady increase to 1.20 percent in 1998. A similar trend is discernible in the case of average return on equity, which declined from 13.8 percent in 1980 to 3.6 percent in 1986 and in the subsequent period showed a steady increase to 11.7 percent in 1998.

Apart from the above trends in the structure, the composition of assets of the banking system has undergone significant changes. Corporate debt of nonfinancial firms in the form of bank loans declined from 20.5 percent to 14.5 percent. Commercial and industrial loans of banks increased marginally from $ 504 billion in 1982 to $ 589 billion in 1994 and were almost equal to the outstanding amount under commercial paper. By the middle of 1990, the largest American Commercial lender and leaser was not a bank but GE capital, the finance arm of the GE group, a leading global conglomerate.

In a similar development, depositors moved away from keeping low interest deposit accounts with the banks to alternate and competing channels such as mutual funds, money market funds, and placing funds with financial service firms. These shifts on both sides of the balance sheet forced the banks to move towards off balance sheet activities more aggressively.

In spite of the decline of banking, particularly corporate banking, the banks in high income countries still hold a dominant position in providing credit as detailed below.

Region or Country	Domestic credit provided by the Banking sector as a percent of GDP	
	1990	1998
Low Income (excluding China & India)	60.0	80.0
	(3801)	(37.4)
MIddle Income	57.9	52.9
High Income	140.0	140.4
France	106.1	103.3
Germany	108.5	145.8
Japan	266..8	137.4
Switzer Land	179.0	177.2
United Kingdom	123.0	129.3
United States	114.6	162.8
World	125.2	126.2

Source : World Development Indicators - 2000, World bank.

As can be noticed from the table that domestic credit provided by the banking sector as a percent of GDP substantially increased USA from 114.6 in 1990 to 162.8 in 1998. Most of the credit expansion has shifted from corporate loans to retail loans. Credit provided by banks world over as a percent of world GDP marginally increased from 125.2 to 126.2 during the same period.

During the period 1990 to 1998 stock market capitalisation as a percent of world GDP increased from 52 percent to 82 percent for the world as a whole, and from 56 percent to 95 percent for high income countries. Stock market developments particualarly in USA, have enabled corporate entities to tap capital markets for meeting their financial requirements rather than seeking funds from the banking sector.

Banks increasingly resorted to the route of finanicial innovations for augmenting revenues and started developing complex financial products. These developments were aided by the technological developments in computers and telecommunications. The theoretical developments in option pricing models have also contributed to the complexity of financial products.

In order to address some of the concerns arising from the off-balance sheet exposures and derivative products, the issue of strengthing the reporting and capital change for such instruments have received greater attention of regulators world over. The proposed Based Accord - II is also addressing various complexities of financial innovations so as to proivde a cushion for capital allocation and structure.

4.13 RESTRUCTURING PROCESS IN INDIA :

a) Commercial Banks :

Twenty seven public sector banks have extensive network of rural and semi-urban branches in the countryside. Each one of them has tremendous concentration in its Lead Districts and thin presence in other districts. Of course, the SBI has extensive network of branches in its several non-

lead districts too. It is, thus, worthwhile to conduct feasibility study of the important recommendation of the Narsimham Committee on Financial Sector Reforms for establishing one or more rural subsidiaries by commercial banks depending upon their administrative set-up, business and spread. Field-level experience reveals that the bank having very few rural branches in the district has high cost of operations and low volume of business. Besides, while quality of assets / loans and recovery performance has been poor, relutance of staff to be posted or to stay there has its own negative impact in the area of branch operations.

Thus, commercial banks, in the absence of having separate subsidiaries, are not in a position to pay undivided attentiion to the specific aspects which can help Rural Financial Institutions deliver services and products as required by rural households and make them financially viable as expected under the financial sector reform programme, such as,

i) Optimum coverage of rural households and harness productive assets of farmers, artisans and other self-employed population in their operational / service area through better credit management.

ii) developing human societies / habitat in tribal, hilly, drought-prone and desert / backward areas.

iii) developing new customised products best suited to the rural households and the area and establishing backward and forward linkages.

iv) creating awareness among farmers in respect of adoption of new technology, use of credit and repayment of loans.

v) Optimising the use of available infrastructure and expanding infrastructure marginally through proper identification process when funds are already available under the Rural Infrastructural Development Fund and with legislators / Members of parliament for area development.

vi) Significant reduction in both overdues as well as non-performing assets thereby improving profitablity of the branch.

vii) increasing high-value business and reducing the cost of operation at branch level.

Most important impact of the rural subsidiaries will be that the chief executive of the subsidiary with his cost effective administrative set up would be in a much better position to change the negative mind set of the staff about the viability of rural lending and adopt appropriate marketing strategy to boost business in a planned scientific manner which has so far been grossly neglected.

Those banks having very thin presence in the district / state / specified geographical area (where few commercial banks, say five to six, have significant concentration of branches and credit operations), may have to consider to swap their branches to these banks for obvious reasons through proper appreciation of long-term interest of their banks and agriculture and rural development of the geographical area rather than making a prestige issue and unhealthly competition. In fact, these banks may in turn get some branches in other area whether they have strong presence both in terms of branches and credit operations.

b) Regional Rural Banks :

Of late, some RRBs have been shown satisfactory performance in respect of improving recovery performance, containing NPAs and making operating profit. While 162 profit-making RRBs

earned a net profit of Rs. 5,440 million in 1999-2000, the remaining 34 incurred a loss of Rs. 1,140 million. The data in respect of 196 RRBs for 2001-02 and 2002-03 indicate that there has been an overall decline in the number of profit making RRBs. The performance of loss making RRBs witnessed a sharp downturn during 2002-03. Low credit-deposit ratio, high level of NPAs and high cost of management including over-staffing are the main attributes for heavy losses. Thus, there is scope to restructive the RRBs as under.

(i) In respect of 55 RRBs, which have wiped out their accumulated losses can continue their functioning but may consider to dissociate themselves from the state government through taking over Government equity by the sponsor bank and employees of RRBs in three years.

(ii) Those banks, which have no operating loss for past three years have only merge accumulated loss, can consider in close consultation with their sponsoring banks and National Bank to formulate a business plan for a span of next five years focusing on sustaining financial viability or considering their merger with other banks including their sponsoring bank's rural subsidiaries.

(iii) In the case of continuous loss making RRBs and having significant amount of accumulated loss, they may have to either close down their operations or let some financial institution or private sector bank or some commercial / business house take over and convert as Local Area Bank for which the RBI may liberalise terms for setting up Local Area Bank, and the Government may consider providing fiscal incentives for a period of five years.

c) Policy Framework :

Private sector banks, by mandate, are expected to lend to farm sector and participate effectively in the government sponsored programmes on lines with public sector banks. However, their commitment and involvement in this respect has been most unsatisfactory and dismal. In fact, these banks having been primarly Indian banks and governed by RBI's directives, should demonstrate their love and affection to assist to country's growth process of agriculture and rural economic development. It is confirmed from the field - level observations that they have the abilities and expertise to participate effectively in this area of rural development through credit disbursal programmes but, they lack in will to respond positively to this mandated prescription. Of course, in their case percentage of indirect and direct agricultural credit may have to be 12 percent and six percent of NBC respectively. Similarly, in view of country's dire need, even foreign banks should also be asked to contribute to the process of farm sector and rural development through provision of credit and investment to an extent mutually agreed upon between the RBI and foreign banks.

d) Equity Participation :

A recourse to public exchequer to salvage weak and inefficient banks cannot be a lasting solution. The Rural Financial Institutions may have to involve and seek commitment from their employees through the subscription of shares / participation in equity upto a specified sum and its dividend may be reinvested to broaden the base of capital of the Rural Finance Institutions. In fact, the stage is ripe to reduce equity of the government from the Rural Financial Institutions progressively, which should be partially be taken over by employees of the Rural Financial Institutions as well as depositors and borrowers. This kind of financial participation by one and all will strengthen the base of the Rural Financial Institutions and improve efficiency of employees considerably. Besides, involvement of Board of Directors comprising depositors and borrowers will pay rich dividend in

terms of mobilisation and deployment of financial and human resources, providing direction and guidance to the chief executive of the Rural Financial Institutions in evolving area specific and customer friendly policy for rural development.

e) National Bank as Central Bank :

Over a period of time, particularly, from the year 1969 when commercial banks have been nationalised and from the year 1975 when Regional Rural Banks commenced their operations, the demand on the RBI has increased considerably in evolving the policy framework for providing credit for farm and non-farm sector as well as rural developing and directing the Rural Financial Institutions for their implementation from time to time in view of pressing circumstances from the Union and State Governments. This role of evolving banking and credit policy now needs to be fully transferred to the National Bank, which has established its identify as a country's emeritus apex bank for the purpose of rural economic development through provision of banking infrastructure. It has the vision, mission strategy and acquired all the required experience, expertise and insight for this area of total integrated rural development including infrastructural facilities needed. It has established offices in the district and has familiarised with the first hand knowledge of the area, people, institutions, their potentials and problems, procedure and the like. Besides, it has access to international funding agencies and demonstrated its capability of conceptualising and operationlising projects funded by these agencies.

4.14 QUESTIONS :

1. Describe about the banking developments in India before 1969.
2. What is the relational for nationalisation of banks?
3. Discuss about the banking structure in India.
4. What is the role of commercial banks in USA?
5. Explain about the policy framework for restructuring banking system in India.

4.15 FURTHER READINGS :

1. Indian Banking Systems, T. Avaswamy, Lavanya Publishing House, Bombay, 1979.
2. Commercial Banking, Read Cotter Gill & Smith, New Jersey, Prentice Hall Inc., 1980.
3. Report on Trend and Progress of Banking in India, 2002 - 03, RBI, Mumbai.
4. Bank Quest, July - September 2003, Mumbai.
5. IBA Bulletin, Vol. XXV, No. 3, March 2003, Mumbai.

Lesson - 5

PERFORMANCE EVALUATION OF COMMERCIAL BANKS

OBJECTIVES :

The purpose of this unit is to introduce to you the performance evaluation of commerce of banks in India - After you have studied this unit, you should be able to know :

- The expansion of commercial banks during post and pre nationalisation phases
- Problems of commercial banks in branch expansion.
- Branch expansion options in Indian context
- Growth of deposits and advances of commercial banks.
- Deregulation of bank interest rates.
- Marketing approach to banking in the global market.

STRUCTURE

5.1. **Introduction**
5.2. **Branch expansion**
5.3. **Progress of scheduled commercial Banks**
5.4. **Problems of branch expansion.**
5.5. **Branch expansion; Indian experience**
5.6. **Branch expansion; the transition phase**
5.7. **Branch expansion options in the Indian context**
5.8. **Deposits and advances of commercial Banks**
5.9 **Category wise deposits of SCBs**
5.10 **House hold preference for bank deposits**
5.11 **Deregulation of interest rates.**
5.12 **Marketing approach to banking**
5.13 **Deposit insurance and credit Guarantee Corporation (D.I.C.G.C)**
5.14 **Questions**
5.15 **Further Readings.**

PERFORMANCE EVALUATION OF COMMERCIAL BANKS IN INDIA

5.1. INTRODUCTION :

Indian Banking has undergone momentous changes since Independence, more particularly after nationalisation, state ownership of banks from July 1969 led to a manifold increases both in terms of number of branches and number of clientele. The emphasis clearly was on using banks as an instrument for rapid social economic development. This objective was largely achieved with huge studies in the areas of employment generation and poverty alleviation. The stress was primarily on quantitative expansion. However, profitability of the banking sector received less importance vis-a-vis the social obligations of the industry.

The very strength of banking lies in the branch network. The growth of branch network particularly of commercial banks will be of importance.

EXPANSION OF BRANCHES DURING THE POST-NATIONALIZATION PHASE :

The Post-Nationalization period has witnessed an unprecedented growth in the branch network of commercial banks. The banks in this period have given particular attention to providing banking facilities in under banked regions and in relatively developed regions at un banked centers. This was due to the fundamental shift in the approach after the nationalization. With the government takeover of all major commercial banks the banking system was made to function as an instrument of development, prior to nationalization this not possible. The study group of the National Credit Council on “Organizational framework for the Implementation of social objectives” under the chairmanship of Dr.. Godgil, observed in October 1962 that there was uneven distribution of credit both geographically and purpose-wise. It was also revealed that bank loans were not widely dispersed and there were credit gaps, particularly in the case of small borrowers. In view of these hard facts and also the diversity of conditions all over the country, an area approach was essential for deposit mobilisation as well as for appropriate credit and financial arrangements. This was the underlying basis of the Lead Bank Scheme formulated in December 1969,

‘LEAD BANK’ SCHEME AND BRANCH EXPANSION :

The area approach in respect of bank financing proposed by the Gadgil Study Group towards the end of 1969, culminated in the Lead Bank Scheme. It had the backing of Narimon Committee also. The Governor of the RBI had appointed a committee of bankers under the chairmanship of F.K.F. Nariman in August 1969 to prepare a programme for creating adequate banking facilities, particularly in districts/regions where such facilities were lacking at the time of nationalizations, The committee favoured a coordinated approach and was of the view that the banks should be allotted particular districts where they would take the lead in surveying the scope for banking development, particularly expansion of credit facilities. The Reserve Bank accepted the recommendations of the Nariman Committee and prepared the “Lead Bank” Scheme. The scheme gave concrete shape to the ‘area approach’ to banking development advocated by the Godgil Study Group.

Under the ‘Lead Bank’ Scheme districts were allotted to the State Bank Group, 14 Nationalized Banks, and 3 private Indian Banks. The Scheme covered virtually the whole country except greater Mumbai, Colcutta, Chennai and the Union territories of Delhi, Chandigarh and Goa. White allotting particular districts to these banks under this scheme certain criteria were kept in mind. In the first place, in the allocation of responsibility in terms of number of districts allotted, resources of various banks were taken into consideration. On this criterion where as State Bank of India Group (the biggest commercial Banking Group) was allotted 69 districts. The Bank of Rajastan Ltd. a small private sector bank, got just one district and it shared the ‘Lead’ responsibility in this district with united Commercial Bank. Secondly, the factor of contiguity defined as clusters of districts was given weighted in allotting ‘Lead Bank’ districts. Thirdly, in most cases the ‘Lead Banks’ were allotted particularly these districts where they already had a number of branches. But why this rule was

violated in some cases is not clear. Finally, the scheme provided that except in some small states, each state would have at least two Lead Banks.

The Lead Bank was assigned a major development responsibility in the district allotted to it. To begin with, it was expected to familiarise itself with socioeconomic conditions prevailing in the district, for this purpose, it was required to undertake a survey of a techno-economic nature. It was expected that from these surveys Lead Bank would be able to collect useful information about resource endowment, economical and social infrastructure pattern of different types of production, possible development schemes and obstacles to development. The surveys could also make it possible to assess deposit potential and credit gaps. The Lead Bank had to identify centers for banking development in the light of this information.

After completing the surveys for all the districts of the country, the district level consultative committees for coordinating banking development activities were constituted by the Lead Banks. The Lead Banks prepared phased programme for banking development, which they implemented with the cooperation of other commercial banks and other financial institutions. The execution of this programme has not been the exclusive responsibility of the lead bank.

5.2 BRANCH EXPANSION :

Access to finance has been considered to be a critical factor in enabling people to transform their production and employment activities and come out of poverty. Financial development, in this context, may enable the poor to obtain access to credit and consequently, improve their economic performance. Accordingly, in many emerging and developing countries, where a significant proportion of the poor remains cut-off from access to credit, Government intervention in the banking sector is perceived to channelise credit to the needy sectors of the societies. The evidence on the success of such interventions in reducing poverty has, however, been limited.

There is some recent evidence that the branch expansion programme in India undertaken since the nationalization had a positive impact on poverty and nonagricultural output. Using data on sixteen major Indian states over the period 1961-2000, the following has been observed

1. Branch licensing rule succeed in encouraging commercial banks in opening branches in backward rural locations.
2. Rural banks managed to reach the rural poor, and
3. Commercial banks offered opportunities for house holds to save. The saving accounts provided households with means of accumulating capital which could be used to invest in various productive activities.

It, thus seems that social banking programs as employed by the Government served to redistribute resources to the rural poor. This would suggest that expanding access of finance to poor, rural poor, rural setting can generate significant social returns.

5.3 PROGRESS OF SCHEDULED COMMERCIAL BANKS :

There has been a phenomenal growth in the branch network of commercial banks resulting in improved average population covered per branch.

Table - 5.1

Expansion of Commercial Bank Branches

Year	Total Number of branches	of which Rural branches
June 1969	8262	1833
Dec 1985	51385	30185
March 1990	59756	34791
March 1995	56260	35008
March 2000	65521	32533
March 2001	65908	32719
June 2002	66259	32394

Source : Various issues of RBI Bulletins, Mumbai

The total number of branches were 8262 in 1969 increased to 65521 in March 2000 of which 32719 were the rural branches. The total number of branches of schedule commercial banks as on June 2003 were 66514.

5.4 PROBLEMS OF BRANCH EXPANSION

The speed and efficiency offered by technology banking on the one hand and the pressure on banks to reduce the transaction costs on the other, has led to the firm view that branch banking is a luxory which cannot be sustained in it's present form. While the need to rationalise and restructure the branch network cannot be disputed, the experience in implementing such a change has thrown up certain areas of caution. They arise mainly from the following :

1. Banks are built on confidence and trust which arise out of human relationships. The move from traditional banking to technology based banking, therefore, should continue to provide for a mechanism to maintain this elements.
2. World experience has proved that the transition to "click and Bank" has been painful process and many well known names have had to reestablish the "Brick And Mortor" branch as an essential part of banking channels to co-exist with electronic deliver channels. Hence, the new terminology "Click And Mortor" is gaining currency.
3. Allied to the entire process in the changing role of banks from merely acting as facilitators of transactions in the financial system to providers of value added services. This role transaction will have to be integrated in the rationalisation of branch network. This will have to be a holiste process involving a well structured product and market segmentation within the branch network.

4. The expectation that switching to large scale electronic banking will result in dramatic reduction in cost may not materialise at the initial stages of technology intake, as customers would demand both types of services for a long time to come. Hence profitability from technology will have to be based on the drive for greater volumes had inducement to customers for availing higher product ranges.

The very strength of banking lies inthe branch network built into the system over the past three decades, which, however, has rendered it cost ineffective and over providing for transactions needs. Side by side, it has also enabled the banking system to remain the most prefered saving option next only to the postal savings for the household prouding a stable and low cost supply of resources. The dilema of branch rationalisation is having to carefully match the need of the organisation to cut cost, optimize technology and yet retain it's retail cachet.

5.5 BRANCH EXPANSION : INDIAN EXPERIENCE

The growth of branch network, particularly of public sector banks, will be of importance. Three phases could be identified.

i) THE FIRST PHASE : The first phase covers nearly two decades (the 70's and 80's) of branch expansion, primarly driven by the objective of covering the unbanked centers in the rural and semi-urban pockets, coupled with intensive branch network in the metro urban centers to sustain profitability. In this connection, the Narsimham committee (1991) describes this approach as "...the assumption that every bank should national in character was perhaps responsible for encouraging public sector banks into expanding into all parts of the country. While public sector banks today would qualify for this defination as a result of their barnch expansion, not only in the region of their origin, but also in the country, this expansion was some what unplanned and haphazard...".
There has been a phenomenal growth in the branch network resulting in improved average population covered per branch.

Table - 5.2

	1969	1990	2000	2002
All Branches of which	8867	60515	65556	66186
Public sector Banks	7246	41847,	45,924,	46118
Private Banks1490	1490	3961	5010	5376
Average popustion per branches	64,000	14,000	15,000	16,000

Source : Various issues of Reports on Trend and progress progress of Banking in India, published by RBI.

ii) Second phase : In the decades that followed, 1990, the need to contain the haphazard growth and bring about a qualitative improvement in the branch network was spurred. This included that introduction of specialized branches as well as expanding branches in a more systematic way in its geographical spread. The opening of the financial sector also witnessed the growth of the provate sector banking during this period.

iii) The phase since 2000 : The banking system has been increasingly looking towards technology based delivery channels and progressive reduction of physical branches the extent possible. While the increase in the number of branches during this period has been about 630, the actual number of branches opened is around 977, there by indicating that there has been a consolidations of branches through the process of closures and conversion into satellite branches. However these efforts have been witnessed more in respect of rural branch pockets.

The ATM expansion in india has made it's mark in the last two years with the number increasing from an almost zero status to aproximately, 7500 today. With the technology upgradations under taken by PSB'S, who planned to enter the ATM circuit in a big way, it is expected that this number will show a dramatic increase in the coming years.

The branch infrastructure in the indian situation is fairly well spread and offer excellent scope of strengthening branch banking through a structured process of rationalisation and consolidation. With the help of technology, the branch network can truly strive to achieve a greater level of customer satisfaction.

The Narsimham committee (1998) has clearly set the tone for greater consolidation within the industry and has left the freedom to the banks through it's observation that: "there a clearly a need for consolidation of structure and this could be brought about essentially through a process of negotiated rather than impossed mergers on profitability consideration and also for reasons of business strategy". The paper deals with various experiences and options in achieving this.

5.6 BRANCH EXPANSION : THE TRANSITION PHASE :

Branch banking will essentially follow a certain pattern of transition from transaction dispenser to relationship management center. While in financially developed countries, this has been a series of stages of evolution for branches to pass through, in our country branches could be co-existing in all the stages depending on the level of technology and location. Identifying and classifying branches by their level of evolution and facilitating branches to migrate to the next level where ever necessary is an important aspect in the process. Such a approach will also provide better insights into consolidation of branch networks and priortising technology implementation.

The transition stages as analysed in the study by IBM financial services in paper. The Branch Line To Better Banking, defines these as the six stages from pure brick and mortor bank to customer relationship center .

i) Old Bricks : Existing branches are volume heavy and cost burden and the driver for their very existance is being challenged. The old bricks must be replaced with "efficient bricks" to handle existing high volume, low value transaction in the most efficient way-this first stage is to be an "efficent branch".

ii) Self - Service Branch : As banks strive to manage the costs, some of the existing low value transaction based services would be moved to a self service model.

iii) Multi - Media Branch : Most of the repetitious, labour intensive transaction-currently handled by tellers-are automated. This not only cuts costs, but also frees staff to provide more value added srvices.

iv) Sales branch : Once expensive branch space and staff are freed from handling the low value, high-cost transactions, the branch can become a sales center, selling products and services that produce revenue. The positioning of the branch is moved from being a cost center to a revenue - generating centre.

v) Wealth management center : The branch moves on to become a high value-added financial services center. It caters to sophisticated customers who no longer simply look for transactional banking products and services.

vi) Customer relationship center : The ultimate position of the branch is as a customer relationship centers, a place to manage and maintain contact with customers. In the blurred competitive landscape of financial services providers. The center also acts to ensure the continued visibility of a bank's brand and service offerings.

To put the above stages of transition in terms of the changes envisaged at the branch level, it can be broadly related to the following changes in its features :

Old bricks changing to efficient branches wil primarily focus on remaining a highly transaction supporting branch with greater efficiency. This will include exclusive arrangement/spin off of high volume transactions, process improvement for specific transactions, customer friendly branch timings, infrastructural layout, service specialisation, etc. Many of our rural and semi-urban branches and quite a few urban branches could quickly upgrade its efficiency parameter through such a strategy. It also envisages a location specific/service specific approach.

Self- service branch and multimedia branch are two stages of automation for shifting counter transaction to self-service mode, based on branch level ATM / cash dispensing machine, terminals for balance enquiry, self operated pass book updaters and phone banking for routine enquiries. At the multimedia stage, the branch is largely freed of counter transactions and hence takes up new avenues of customer service like utility service payments and specialised retail banking products and services.

Sales branch is attained at a stage when customers are accustomed to meeting their transaction requirement through offsite mode like ATMs, point of sale debits, Increased usage of credit cards and phone banking for routine enquiries an internet banking too making visible impact. The branch, at this stage, enters into extended areas of services like marketing mutual fund products, insurance products and advanced banking products based on networth of customers. Such branches will be a part of network of branches extending sales and services to bank customers.

The wealth management center and customer relationship centre are further progression in branches becoming a truly relationship management centre. While wealth management centre would continue to offer certain transaction facilities, customer relationship centre will purely focus on

giving adivisory services to customers on all financial services and products and constantly provides information to people seeking advisory guidance on financial products and services and financial planning. Internet banking plays a major role in suplementing brand / image building process.

To sum up and take it further it may even perhaps be to our advantage to draw from these experiences and deliberately create branches in one or more of these stages at different pockets amidst a conlomerate of our branches to cater to the emerging customers' need. This will enable to address the consolidation and closure of branches as well as technology implementation in a cost effective way. Such a proactive aproach to branch transformation will make the entire process smooth and facilitate value addition to the customers in keeping with their demographic progression.

5.7. BRANCH EXPANSION : OPTIONS IN THE INDIAN CONTEXT

i) Selctoin of technology based delivery channels :

The analysis brought out so far clearly provides the route for branch consolidation and technology options in nurturing the same. As most banks in india are in process of major technology initiatives, particularly through inter linking of branches and networking of ATMs, the preferred areas and offset modes brought in the studies could be used judiciously to bring down a trageted level of transactions at branches.

ii) The metro urban scope :

The next bench mark would be the level of concentration of the branch network which obviously would lead to the extensive branch coverage at mero urban centers which, by far, would be one of the highest in the world. These were created at a point of time, when the growing customer profile at metros/urban centers benefited the banks to augment business opportunities and support and encourage rural operations. They were primarily transaction driven opportunities.

The approach to branch consolidation so far seems to have focused on the rural areas primarily beacuse of it's relatively low business volume and the logistics of managing far flung outlets and as result underplayed the scope in the metro urban pockets. The absence of technology which is now being bridged, has been another inhibiting factor in the undertaking resetting of metro urban networks on a large scale.

In the light of this, though it is neither a prescription nor a prediction, it can be roughly estimated that a third of the branch networks in the metro urban centers can give way to ATMs and other offsite delivery modes. The remaining two-thirds would then have to be reset as efficient branches falling under the category of multimedia branches, sales branches, wealth management centers of and customer relationship centers as explained in the transition phase earlier. This phase should preferably be accomplished in the next three years if tangible impact is to be felt.

iii) option for rural branch banking :

As regards branches in the rural centers, the old brick and mortor branches would continue in most areas with growth opportunities in keeping with economic progression in agriculture and

other allied sectors. Automation would, however, provide adequate scope for reduction of transaction costs and improving efficiency.

Considering the destinction with which public sector banks, have under taken social banking and turned them viable, taking new genration technologiy like atms and telephone banking to select rural pockets should be taken up at first available opportunity without looking at the immediate cost benefit angle. parallels can be drawn from the success with which internet benifits have been harnessed by government agecies and NGOs at many centers to positively impact on the rural masses. Infact, banks which have now established a good working relationship with NGOs and self help groups in promoting rural enterprises can sucessfully extend the invlovement of these instutions in creating interest in technology banking among the rural masses.

Major gains can also be achieved in branch realignment in rural pockets through swapping of branches by PSBs. It will be to the benefit of the banking system consolidate the branch networks, targeting reallocation within districts and blocks among banks. This will make the logistics of managing the branch networks easier, facilitate interconnectivity trough short range net working cluster branch processing for back office funtions and above all creating a crictical mass for maximising business opportunities.

To sum up it is necessary to pursue a well conceived policy focused on the following steps :

1. The process of branch consolidation and electronic delivery channels to make it's mark in major / urban centers where branch banking is over proved and cost ineffective.
2. Different options of technolohy banking and delivery channels like atms, internet banking, phone banking should be kept open and offered in proper sequence since all of them have their appeal for different segments.
3. Inter connectivity should be related with customer requirements and preferred transactions rather than aiming at merely increasing the number of interconnected branches.
4. A well conceived incentive/deterrent pricing policy to be followed for encouraging the usage of electronic delivery channels which are mutually profitable.
5. Strategic alliance berween banks will open up venues for branch rationalisation in rural areas and electronic delivery channels at metro/urban centers.
6. Allied to this be the challenge of redeploying manpower which is of particular relevance to public sector banks of the country. This will be a integral part of the branch transformation process essentially requiring a large number of relationship managers a role that will be demanded from many who are presently engaged in routine back office functions and counter transaction providers.

The indian banking scenario has the dual advantage of selecting the best of the technology and branch transformation based on the experience of the developed financial marketers.

Nevertheless, a bold initiative to reduce the number of branches substantially cannot be over looked, particularly in the context of the increased cost of the real estate and higher manpower content required for extensive branch outlay.

It may be worthwhile to take a closer view on the opportunities available to the public sector bank in realigning branch network through a process of inter bank dialogue, the tone of which was set by the Narsimham committee (1998). This may call for a proper frame work which can be entrusted to a working group consisting of members from the public sector bank, training and reasearch institures connected with banking and professional bodies. This could pave the way for new initiatives in this direction.

In conclusion, it can be said with certainly the branch would eventually emerge as link between the traditional cost ineffective banking to revenue generating service providing outlets which increses business volumes by building on quality customer relations and in time, shape customer behaviour. From this point of view branch banking is far from being extinct : infact, it has entered a more challenging and demanding situation to retain and acquire customers.

5.8. DEPOSITS AND ADVANCES OF COMMERCIAL BANKS:

The operations of scheduled commercial banks were charecterised by a significant acceleration in deposit growth, and substantial deceleration in the expansion of bank credit point. The deposits and advances of scheduled commercial banks as on December1969 stood at Rs. 4822 crore and 3467 crore respectively. The advances fo scheduled commercial banks rose from Rs. 3467 crore in1969 to Rs 24,760 crore in1980, to Rs. 1,21,984 crore in march 1990 and to Rs. 4,60,081 crore march 2000. The advances of scheduled commercial banks as on march 2003 stood at Rs. 7,59,210 crore (see Tobal 5.3)

Table - 5.3

Deposits and advances of scheduled commercial banks

(Rs. in Crores)

Year	Depoits	Advances	C.D ratio
Dec 1969	4,822	3,467	71.90
Dec 1980	36,997	24,760	66.93
Mar 1990	1,84,961	1,21,984	65.95
Mar 2000	9.94,433	4,60,081	56.7
Mar 2001	11,23,393	5,38,434	58.4
Mar 2002	11,92,369	6,55,993	56.9
Mar 2003	12,78,667	7,59,210	59.4

Source : Various issues of Report onTrend and progress of Banking in India, Mumbai.

The gross bank credit recorded higher growth during march 2003 as compared with previous year. There was a sharp acceleration in non-food credit, driven mainly by acceleation in advances to industry (medium and large) and housing.

There is a substantial growth in deposits of scheduled commercial banks in India. The deposits were Rs 4,822 crore in December 1969 increased to Rs. 36,997 crore in 1980 in December to 1,84,961 in March 1990 and to 9,94,433 in March 2000. The deposits of S.C.Bs were Rs. 12,78,667 crore as on march 2003. The higher growth in deposits was mainly on account of sharp increase in demand deposits, which in turn, was primarily due to increase in inward remittances from abroad and accruals to banks in terms of rupee counter part of the subscription to the India devolopment bonds.

The credit deposit ratio : an important indicator of bank's perfomance declined from 71.9% in Dec. 1969 to 65.95% in mar 1990 and to 59.4% im Mar 2003.

RURAL CREDIT - DEPOSIT RATIO

It is not only that the rural branch network has stagnated but also that the relative sizes of rural deposits and credit have receded, and above all, the extent of credit deployed from out of deposits mobilised. In rural areas has rapidly fallen. Because of the population census data from time to time, the comparability of banking data by population groups has been affected. The shares of rural as well as semi urban branches in aggregate deposits and credit have declined in the 1990s. The rural C-D ratio which was over 65 percent slipped to around 42% now (as on mar 2003). Similarly, the C-D ratios of semi-urban branches, which had remained around 49-50% until the early 1990s, have declined rather precipitately and touched 35% in September 2003. This is contrary to the 60% C-D ratio prescribed by policy for rural and semi-urban branches.

5.9 CATAGORY -WISE DEPOSITS OF SCHEDULED COMMERCIAL BANKS

The main source of deposits in commercial banks was term deposits. The term deposits have percentage in all the years in the deposit mix of comercial banks. Commercial banks are also able to moop-up the savings of small income groups in rural and urban areas. The saving bank deposits were Rs 25,563 crore in 1985 increased to 48,497 in March 1990, to 94,573 in Mar 1995 and to 2,32,241 in Mar 2001. The saving bank deposits stood at Rs. 2,72,543 crore as on Mar 2002. The term deposits which were Rs. 47,157 crore in Dec 1985 increased to 7, 25,216 in Mar 2002. The increase in current deposits is also significant. The current deposits were Rs. 13,202 in Dec 1985 increased to Rs. 62,081 crore in Mar 1995 and to 1,25,635 in Mar 2002.

Table - 5.4

Category-wise deposit of commercial Banks

Year	Current	Saving	Term	Total
Dec. 1985	13,202	25,563	47,157	85,922
March 1990	26,047	48,497	97,397	1,71,911
March 1995	62,081	94,573	2,22,520	3,79,174
March 2000	1,05,458	1,99,734	5,16,228	8,21,420
March 2001	1,15,736	2,32,241	6,01,456	9,49,433
March 2002	1,25,635	2,72,543	7,25,216	11,23,393

Source : 1) RBI, Banking statistics, Quarterly Handout various issues, Mumbai.
2) Economic & Political Weekly - March 20-26, 2004, Vol. XXX IX No.12, Mumbai.

As shown in table - 5.4, the total deposit of scheduled commercial banks increased from Rs. 85,922 Crore in Dec. 1985 to Rs. 3,79,174 crore in March 1995. The total deposits were stood at 11,23,393 crore in March 2002.

5.10 HOUSEHOLD PREFERENCE FOR BANK DEPOSITS :

The above proposition derives its rationale from the fact the despite considerable diversification in the financial system, the household preference for bank deposits as a savings medium has been continuing uninterrupted. Bank deposits as percentages of incremental financial assets have risen from 32.1 per cent in 1995-96 to 37.8 percent in March 2002. With a relative shift of interest rates in its favour, the share of term deposits in total deposits have gone up from 56.6 percent in March 1990 to 64.6 percent in March 2002. It is the increase in term deposits share at the cost of both current account and savings deposit account that has been most striking.

Rural and semi urban areas have a fairly high share 30 to 33 percent in the form of savings deposits too. Also despite the absence of any attraction of higher interest rates, 'Individuals' preferred to hold over 30 percent of term deposits for long maturities of three years and above in March 2002 as against 43 percent held in March 1990, or 32 percent in March 1996.

The absence of worthwhile social security system, the assurance of safety in the form of public sector ownership of banks and the inability on the part of the common man to move in favour of sophisticated saving instruments, have been responsible for the continued preference of households for bank deposits, which imposes as heavier responsibility on banks to deliver credit equitability.

5.11 DEREGULATION OF INTEREST RATES :

Interest is the cost of funds from the borrowers point of view while it is the yield on capital from the lenders point of view. Interest rates in India are now at historic lows.

Over the last five years a regime of low interest rates has set in for the Indian economy. Despite the implementation of reforms, structural rigidities remained in interest rate structure distorting the true market-determined rates. Rates has been kept artificially high by offering high-administered rates on small savings and provident fund. The gap between the short-term and long-term rates tended to remain high on account of this. The interest rates had been and continue to be very high relative to the prevailing in global markets.

Industrial growth is a pre-requisite for economic development. Every industry requires finance for the establishment, expansion and working capital management. Bank credit is considered as the most important source of industrial finance in India. The dependence on bank for finance could vary according to the size of the companies and to the availability of the credit at lower cost. The small-scale industrial units depend on banks for credit because they have virtually no access to the capital market.

Against the backdrop of slowing Indian economy, bank rate and administered rates on small savings have been cut. Added to this the Reserve Bank proclaimed the policy of pursuing lower interest rate regime. With the US economy signalling lower interest rate it appears as if the global

economy is bracing lower rate regime as well. Globalization will ensure that India will not remain immune to this global phenomenon. Through this paper, we attempt to contemplate the following aspect of 'Lowering of Interest Rates' and study the impact. We put forward some concrete suggestions for the betterment of the economy and banking sector.

- The effect of Interest rates on money supply, aggregate demand, inflation, stock prices, exchange rates etc.,
- Lower interest rates and India Inc.
- Lower Interest rates and the common man.
- International scenario.
- Sentiments of the common.

INTEREST RATES AND THE ECONOMY :

Monetary policy aims to influence the overall level of monetary demand in the economy so that it grows broadly in line with the economy's ability to produce goods and services. This stops output rising too quickly or slowly. Interest rates are increased to moderate demand and inflation and they are reduced to stimulate demand. If rates are set too low, this may encourage the build-up of inflationary pressure; if they are set too high, demand will be lower than necessary to control inflation. How does this work ?

THE BANK RATE :

Monetary policy operates by influencing the price of money, i.e., the cost of borrowing and the income from saving. The Reserve Bank of India sets the bank rate. This is an interest rate for the Reserve Bank's own market transactions with financial institutions - the rate at which the Reserve Bank will make short-term loans to banks and other financial institutions. This rate is known as the bank rate.

FROM THE BANK RATE TO INFLATION :

Changes in the Bank rate then affect the whole range of interest rates set by commercial banks, other financial institutions, etc., for their own savers and borrowers. It will influence interest rates charged for overdrafts and mortgages, as well as savings accounts. A change in the Bank rate will also tend to affect the price of financial assets such as bonds and shares, and the exchange rate. These changes in financial markets affect consumer and business demand and in turn output. Changes in demand and output then have an impact on the labour market - employment levels and wage costs - which in turn influence producer and consumer prices.

BANK RATE TO PRIME LENDING RATE AND DEPOSIT RATES :

As there is a positive correlation between cut in Bank rate and movement in interest rate, most banks make downward adjustment in their respective lending and deposit rates following slash in Bank rate. While cut in lending rate would bring down the interest income, it is only logical that most banks would try to compensate for the loss of income by bringing down the interest out-go

through adjustment in deposit rates so as to neutralise the impact on their net interest income. To that extent, this would definitely reduce their cost of funds as also bring down the interest income.

The Effects on Demand - Spending and Saving Decisions :

When interest rates are changed, demand can be affected in various ways. A change in the cost of borrowing affects spending decisions. Interest rates will affect the attractiveness of the spending today relative to spending tomorrow. An increase in interest rates will make saving more attractive and borrowing less so. This will tend to reduce current spending, by both consumers and firms. That includes spending by consumers in the shops and spending by firms on new equipment, i.e., investment, Conversely, a reduction in interest rates will tend to increase spending to consumers and firms.

CASH FLOW :

A change in interest raes will affect consumer's and firms' cash flow. For savers, a rise in interest rates will increase the money received from interest-bearing bank and other deposits. But it will also mean higher interest payments for people and firms with loans - debtors - who are being charged variable interest rates (as opposed to fixed rates which do not change). These include many households with mortgages on their homes. These fluctuations in cash flow are likely to affect spending. Lower interest rates will have the opposite effects on savers and borrowers.

ASSET PRICES :

A change in interest rates affects the value of certain assets, such as house and share prices. Higher interest rates increase the return on savings in banks and PPF. This might encourage savers to invest less of their money in alternatives, such as property and company shares. Any fall in demand for these assets is likely to reduce their prices. This reduces the wealth of individuals holding these assets, which in turn, might influence their willingness to spend. Again, lower interest rates have the opposite effect; i.e., they tend to increase asset prices.

STOCK PRICES :

As seen above, ordinarily, the significant fall in interest rates can be expected to reflect in higher stock prices. Long-term interest rates have declined more than 25 percent in the last year and half. However, a commensurate increase in stock prices has failed to happen. Indeed, index values are virtually at levels seen in June 1999 - since then, long-term interest rates have come down from around 12 percent to close to 8 percent now. A probable reason for this phenomenon is that given the uncertainty in the Indian as well as global markets, the investors prefer to stay liquid.

EXCHANGE RATES :

A particular influence on prices comes through the exchange rate. A rise in interest rates relative to those in other countries will tend to result in an increase in the amount of funds flowing into India, as investors are attracted to the higher rates of interest. This will tend to result in an appreciation of the exchange rate against other currencies. In practice, the exchange rate will be influenced both by expectations about future interest rates and any unexpected changes in interest rates. That is

because if investors expect interest rates to rise they may increase the amount they invest in a currency before interest rates actually rise. So there is never a simple relationship between changes in interest rates and exchange rates. Other things being equal, an increase in the value of the Rupee will reduce the price of imports. In addition, a higher Rupee will tend to reduce the demand abroad for Indian goods and services.

Table 5.5 - Trend in Bank Rate

Date	Change in Bank Rate
April 2, 1998	Reduced to 10.5 to 10%
April 29, 1998	Reduced to 9%
March 1, 1999	Reduced to 8%
April 1, 2000	Reduced to 7%
July 2000	Increased to 8%
March 1, 2001	Reduced to 7%
April 1, 2002	Reduced to 6.5%
October 26, 2002	Reduced to 6.25%

Source : Report on Trend and Progress of Banking in India, RBI. December 1999, page 3 and RBI Announcements in 2000, 2001 and 2002.

Table 5.6 Interest Rate Cut - Small Saving Schemes

Scheme	2002	2001	2000
PPF	9.0%	9.5%	11.0%
NSS	9.0%	9.0%	10.5%
NSC	9.0%	9.5%	11.0%
Post Office Savings	3.5%	3.5%	4.5%
Post Office Time Deposits	7.25%	7.5%	8 (1 year)
	7.5%	8	9 (2 Years)
	9.0%	9	10.5 (5 Years)

Source : Union Budget Document 2002 and 2001, Ministry of Finance, Government of India.

Table 5.7
Trends in Prime Lending Rates (PLR) of Commercial Banks

Year	Interest Rates (%)
1999 - 2000	12 to 12.5%
2000 - 2001	11 t 12%
2001 - 2002	11 to 12%

Source : RBI Bulletin, September 2002.

5.12 IMPACT OF LOWER INTEREST RATES :

India's current real interest rates are one of the highest in the world. They result in inflating the cost of production making the industry less competitive in the world market. The economic survey has clearly stated that India is going through a pahse of slowdown. All three sector viz., agriculture, industrial and services sectors are showing signs of slower growth. To stimulate the growth, government will have to bring interest rates down. The reduction in interest rate will have a two fold effect :

a) It will bring down the interest burden of the corporates ;

b) it will help reduce cost of capital.

The reduction in cost of capital will stimulate industrial growth and investment.

It will also enable the small and medium industries to compete with cheap imported products that have been flooding the Indian markets post globalisation.

THE FEEL GOOD FACTOR :

Cut in interest rate at this stage is a step in the right direction. This is more so in view of the fact that the economy, in general, was expecting a boost in the form of policy support. Immediate fall out of this step would be two-fold: one, It's a definitive step towards a low-cost economy, and the other, which is more important, is that it creates a "feel good" atmosphere when the economy is going through "slow down". Obviously, lower interest rate regime will facilitate the economy traversing a high-growth trajectory. Hence, the positive activism in the industry will certainly enthuse the financial markets in a big way. The cut in interest rates has certainly had a positive impact on market sentiment.

5.12 MARKETING APPROACH TO BANKING :

The world of banking has changed considerably. The forces of globalisation and technology have resulted in increasing integration of economies across the world. Today banks are no more competing locally, but in the global market place. It is important for banks to adopt to this new environment. In the words of Karen Kaiser Clark: "Life is change, Growth is optional. choose wisely".

The banking sector in India has witnessed rapid deregulation. Today's customers have a wider range of products to choose from. In order to service this ever increasing customer demand, banks, which were highly branch focussed are concentrating on multi-channel delivery. This enables them to reach out to customers in any part of the world. Further the one-size-fits-all approach has been replaced with an approach based on customerisation and innovation. Thus today's banks have become more customer centric.

In the wake of these changes, the Indian banking industry has witnessed several positive developments. Interest rates have been deregulated. There is provision for foreign currency clearing in the domestic market. We are also one of the first countries where liquidity and interest rate risk management is mandated by the central bank.

Banks need to maintain high levels of operational efficiency in order to be competitive. For this the key is to make optimal utilisation of resources at their disposal. Operational efficiency can be of two types - short-term and long term. Short-term efficiency covers application or process specific initiatives, which result in cost saving and service improvements. In order to achieve long-term efficiency, it is necessary t understand the relationship between cross-functional applications and processes. Cross-functional efficiencies have a long-term impact on the business. Customer management is more crucial today than ever before. Globalisation and information revolution have raised customer expectations, they expect custom services at ever greateer speed.

CHALLENGES OF MARKETING :

This is a major challenge for the Indian banks over the coming decade. At the move strategic level, Indian customers and their behaviours are not well understood. At the branch level, their needs are not being adequately identified. This lack of customer focus permeates throughout the industry and is characterised by generally poor service.

This this situation exits is a consequence of the highly regulated market. The Indian bank customer is, by and large, not aware of their market power, but all this is rapidly changing. A note of caution, banks risks a customer backlash once they realise their power, and this can have a serious effect on the viability of banks business model. Good examples of this are to be found in the canadian and Australian markets, where “bank bashing” has become a favourite pastime.

i) The marketing function :

Banks firstly need to understood the difference between marketing and selling, and to establish the marketing function with in their organisation structure. However, there is little real experience in this field available within the banking industry in India. It may therefore be timely for the banks to consider recruiting from the FMCG field, as the likely source of people to properly establish this function.

With in the banks there needs to be clear accountability for both customer and product, and the two need to be analysed and understood in minute detail.

ii) Image :

The image of banks in India is not a positive one, nor is it an overtly negative one. The media is not negative towards banks at the moment, but this situation could change. Strict adherence to a consumer banking code at the corporate level, and personal adherence to a professional code of ethics, is mandatory. Banks cannot afford to accept anything less. The IBA has an important role to play in this regard.

Some individual banks have done some work on creating an image for themselves, and those banks that have not, need to be doing something soon if they wish to differentiate themselves and continue to complete in an increasingly competitive market.

iii) Distribution :

The Indian banking industry is characterised a large number of banks and a large number of bank branches. Often, because bank (A) has established a branch, bank (B) feels it also needs to for competitive reasons. Neither bank (A) or (B) have probably done sufficient analysis of the local market. There also appears to be a perception that credibility (safety) is some how linked to the number of branches, not to quality of assets (including human assets).

There needs to be further rationalisation of both banks and branches in India. Before bank can think about closing a branch, or opening a new one, it has to better understand the dynamics of its branches. The obvious target of any rationalisation would be rural branches, but so little is really known about the dynamics or future potential of that segment. Leaving aside the viability issue, great care will need to be given in the impact of any closure on customers, and to the imagae of the bank.

PRODUCT :

Due to lack of historic data and the previously highly regulated market, little is really known of the profitability of individual products. Over all, products tend to be customer-friendly, meaning that the terms and conditions are very favourable to the customer. The fixed deposit product, which is more like a call deposit in practice, is an example of this. Allied to this, is the savings account “Sweep” product. These products are definitely not bank friendly.

To some extent, suitable interest margins and fees compesate for generous terms and conditions. However, increased competetion tends to erode these margins and fees over time. This leaves generous terms and conditions. Which, when clawed back, can cause a major customer backlash. To avoid this, now is the time to start to better understand the true profitability and trade offs built into each product, and to plan ahead for the future competetive environment. To this end, a product management function needs to be established, which, amongest other accuntabilities, launches and occasionally exits, with draws products.

v) Relationship selling :

Indian banks are yet to fully embrace the concept of relationship selling. Because banks do not know their customers well, nor their needs, they are not able to establish a deep relationship with them. one that depends on value not price. It can provide the tools that are a means by which customers can be given the type of financial solutions and recognition that they needed.

This overall objective of relationship selling should not be just to sell more product, but to sell more product to each customer, according to their needs. This leads to improved customer profitably, and lower acquisition / serving costs. There also a positive correlation between increased product penetration and reduced attrition rates.

5.13 DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION :

Bank failure will have serious consequences for the depositors and adversely affects the development of banking system. It destroys the savings of the depositors, shalters the confidence of the public in banking system and generates deflationary tendencies in the economy. Deposit

insurance is necessary for the sound and efficient working of the banking system. It inspires confidence among the depositors and prevents panicky withdrawals from the banks. The failure of the Pillai Central Bank and Lakshmi Bank in 1960 gave a shock to the public confidence in the banking system of the country. With a view to provide protection to the small depositors, the Deposit Insurance Corporation was established in 1962.

CREDIT GUARANTEE SCHEMES :

The main reason for reluctance of banks to provide finance to the small borrowers has been the high degree of risk involved in lending them. Some institutional arrangements are therefore necessary to cover the credit risks of the lending agencies. The basic principle underlying the institutional risk coverage is the principle of insurance of pooling individual risks according to which the statistical law of large numbers considerably reduces the credit risk per unit of credit. In India two credit schemes have been operating.

1. Credit Guarantee Scheme for Small Industries :

In July 1960, the Government of India in consultation with Reserve Bank of India, started a credit guarantee scheme for small scale industries. The objectives of the scheme was to encourage institutional lending institutions against possible losses with respect of such loans. The RBI has been entrusted with the task of administering the scheme as the agent of the Government of India and has been designated as the “Guarantee Organisation” for this purpose.

Under this scheme guarantee is provided to the loans extended to the small scale industrial units engaaged in

a) manufacture processing or preservation of goods.
b) mining or quarrying
c) servicing and repairing of certain types of machinery and
d) custom service units.

The scope and the provisions of the scheme have be liberalised from time to time.

2. Credit Guarantee Corporation of India :

In order to encourage the banks to provide credit to the small borrowers on a large scale without excessive risk, the Credit Guarantee Corporation of India was established in January 1971. The main objective of this corporation was to provide grarantee cover to the banks in respect of loans granted to the small borrowers like small transport operators traders, artisans, self-employed persons, small business enterprises, farmers etc.

Deposit Insurance and Credit Guarantee Corporation of India (DICGC) :

In July 1978, the Credit Guarantee Corporation of India was merged with the Deposit Insurance Corporation. The new institution has been renamed as the ‘Deposit Insurance and Credit Guarantee Corporation of India’. The new corporation has to serve two objectives :

a) to provide insurance protection to small depositors; and
b) to provide credit guarantee to the banks for loans to extended to small borrowers.

Deposit Insurance :

The corporation provides insurance cover to the commercial banks, regional rural banks and cooperative banks. It changes a premium of 4 paise per annum to every hundred rupees of deposit and has fixed the amount of insurance cover at 13,30,000 per depositor. Total deposits insured is increasing considerably every year.

Credit Guarantee :

The corporation is operating three types of credit guarantee schemes.

a) small loans guarantee schleme
b) small loans (financial corporation) guarantee scheme and
c) service co-operative societies guarantee.

The facility of credit guarantee is available to the commercial banks, regional rural banks, cooperative credit institutions and financial corporations. Advances to farmers and agriculturalists, account for about 41% of the guarantee cover and advances to transport operators and retail traders account for about 12% of 13% of the cover respectively.
Credit Gurrantee for small scale industries :

Credit Guarantee for Small Scale Industries :

In March 1981, the Government of India closed its credit guarantee scheme for small scale industries and DICGC started small loans guarantee scheme. The objective of this scheme was to extend guarantee cover for the loans granted to small scale industries. The scheme is available to all commercial banks, regional rural banks, state financial corporation etc., and the participation in the scheme is voluntary.

CREDIT GUARANTEE FOR COOPERATIVES :

In july 1984, the DICGC introduced small loans (cooperative banks) guarantee scheme with a view to extend the facility of guarantee cover to primary (urban) cooperative banks in respect of their loans granted to transport operators, retail traders, small business and professional and self employed persons. The advances guaranteed under the scheme increasing every year.

5.14 QUESTIONS :

1. Discuss about bank expansion policy of commercial banks during pre and post nationalisation periods.
2. What are the problems in the expansion of branches in India?
3. Discuss about the advances and deposits position of commercial banks in India.
4. How deregulation of interest rates benefit banks?
5. Explain the role of banks in changed market environment.

5.15 FURTHER READINGS :

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2. ‘Commercial Bank Management’, Edward E.Reed, (New York Harper Row) 1964.
3. Various issues of Report of Trend and Progress of Banking in India, Mumbai.
4. ‘Two decades of Indian Banking - the service sector scenario”, Sushila Thakur, Chankeya Publications - Delhi.
5. ‘Money Banking and International Trade’ R.R. Paul.

Lesson - 6

INVESTMENT POLICIES AND PROCEDURES COMMERCIAL BANKS

OBJECTIVES :

The purpose of this unit is to introduce to you know about investment policies of Commercial Banks. After you have studied this unit, you should be able to know :

* Meaning and Types of Investments
* Nature of Investments and need for the Investments.
* Investment Policies of scheduled Commercial Banks.
* Policy developments relating to Bank's investments.
* Capital Adequacy Norms - Recommendations of Narasimham Committee.

STRUCTURE :

6.1 Introduction
6.2 Definition of Investment
6.3 Nature of Investment
6.4 Factors influencing for Investment
6.5 Need for Investment
6.6 Investment Policies of Scheduled Commercial Banks (SCBs)
6.7 Aggregate investments of SCBs
6.8 Bank group-wise investments of SCBs
6.9 Investments of SCBs in State-level-securities
6.10 Major recent policy developments relating to banks investments
6.11 Capital adequacy Norms - Recommendations of Narasimham Committee
6.12 Questions
6.13 Further Readings

6.1 INTRODUCTION :

The emerging economic environment of competitive markets signifying customers sovereignty has profound implications for the savings and their investments in India. Investment means a persons commitment of funds towards his future life. It is an economic activity. It refers to acquisition of assets which generates income. It means the diversification of money towards investment and thereby increasing productivity of a nation. Investment means parking of one's idle funds in income generating assets.

The term investment refers to funds invested in various securities. Consisting of Govt and Semi-Govt securities, Loans, Debentures of local authorities, such as port trusts, municipal corporations and debentures and shares of companies. Investment represent legal claims of various securities, such as Bonds, Shares, Debentures etc, and are assets of special nature. There are various forms of investments available with their relative merits and demerits. Investments are freely bought and sold in the stock exchange through banks and brokers, who charge a small amount of

commission for their services. Investment means the use of money to earn more money by way of interest, dividend or capital appreciation well planned investment alone can ensure regular income, capital appreciation and can be used to meet the financial requirements of the investors. The dynamics of economic growth provide various opportunities for investors to invest their money in different types of securities.

The Financial and Economic meaning of investment is related to each other, because investment is a part of the savings of individuals, which flow into the capital market either directly or through institutions divided into new and secondary capital financing. Investors as suppliers and users of long terms funds will find a meeting place in the capital market.

Investment will generally be used in its financial sense and as such. Investment is the allocation of monetary resources to assets that are expected to yield some gain or positive return over a given period of item. Investment is a commitment of a person's funds to derive future income in the form of interest, dividends, rent, premium, pension, benefits or the appreciation of the value of his investment. In the process of investment the transfer of financial assets will be made from one person or institution to an investor. Investments will include various kinds of instruments or securities and institutional media into which savings are placed.

6.2 DEFINITION OF INVESTMENT :

According to F. Amling "Investment may be defined as the purchase by an individual or institutional investor of a financial or real asset that produces a return proportional to the risk assumed over some future investment period".

Fisher and Jordan defined investment as "commitment of funds made in the expectation of some positive rate of return. If the investment is properly undertaken, the return will commensurate with the risk the investor assumes".

The term investment can notes different concepts and meanings. The important three concepts of investments are explained below -

a) Economic Investment
b) Commitment Investment
c) Financial Investment

a) ECONOMIC INVESTMENT :

Economic Investment means the net additions to the capital stock of the society which consists of goods and services that are used in the production of other goods and services. Addition to the capital stock means an increase in buildings plants. Equipments and inventories over the amount of goods and services that existed.

b) COMMITMENT INVESTMENT :

Commitment Investment refers to money commitment to satisfy personal desires, since no rate of return is involved in such investment nor capital growth is expected. For ex : a commitment of money to a new car is certainely an investment from an individual point of view.

c) FINANCIAL INVESTMENT :

It involves the investment of funds in various assets, such as Stock, Bonds, Real Estate,

Mortgages etc. Investment is the employment of funds with the aim of achieving additional income or growth in value. It involves the commitment of resources which have been saved or put away from current consumption in the hope some benefits will accure in future. Investment involves long term commitment of funds and waiting for a reward in the future.

6.3 NATURE OF INVESTMENT :

Investment requires a continuous flow of decisions which cannot be avoided. All investment choices are made at points of time in respect to personal investments and in contemplation of an uncertain future. Investors in stock market will from time to time reappraise and revaluate their various investment commitments in the light of new information changed expectations and ends. Investment choices are found to be out comes of the following different but related classes of factors.

The investment decisions are based on many streams of data which taken together, represent to an investor the observable environment and the general and particular of the securities and enterprises in which he may invest.

Investing has been an activity confined to the rich and business class in the past. This can be attributed to the fact that availability of investible funds is a pre-requisite to deployment of funds. But today, we find that investment has become a household word and is very popular with people from all walks of life. According to the quick estimates of the central statistical organisation. The gross domestic savings reached a new peak of 25.6% of G.D.P at current market prices which was an improvement over the previous peak of 24.9% in 1994-95. Overall, the higher saving rate lead to phenomenal increase in investment activities.

6.4 FACTORS INFLUENCING FOR INVESTMENT :

Increasing popularity of investments can be attributed to the following factors :

A) Increase in Investing population

B) Availability of Tax Incentives

C) Tendency of people for Investment

D) Availability of Investment Opportunities

E) Increase in Investment related Information

A) INCREASE IN INVESTING POPULATION :

The Indian capital market has been growing tremendously during the last decade, India is having the largest number listed companies in the world. Investment in shares and debentures has become a major source of income at present days. The country boasts of entertaining a large number of shareholders for Ex : The largest number of unit holders being 65 lakhs in UTI's master gain - 1992. After implementation of privatisation, liberalisation and globalisation policies, the investment habits increased among the Indian citizens. At present the investors in India is about more than 1.25 crores. While comparing with the developed markets, India is still backward in investing population.

B) AVAILABILITY OF TAX INCENTIVES :

The investment in securities can not be made without considering the various provisions of

the tax laws. The investor may find that most of his profits have eroded by the payment of taxes. A tax planning could lead to a substantial increase in the amount of savings. Various tax incentives offered by the Government make this possible. Provisions of Income Tax Act, and the Wealth Tax Act are important to an investor in planning investments. According to the Income Tax Act, the gross total income of an individual is computed in the following heads :

a) Income from salaries
b) Income from house property
c) Profits and gains of business or profession
d) Capital gains
e) Income from other sources

The incidence of incometax depends on the residential status of an individual. Income by way of Interest, premium, issued by the central government is exempt from income tax. There are so many exemptions and deductions available to the investors under Income Tax Act, and Wealth Tax Act.

C) TENDENCY OF PEOPLE FOR INVESTMENT :

The emerging economic environment of competitive markets, signifying customer sovereignty, has profound implications for the savings investment market in India. As household's sector share is over whelmingly large in the country's savings, after implementation of government policies since 1991. Household savings constitute around 82% of India's gross domestic savings. Approximately half of this takes the form of financial saving. Rapid changes are occurring all over the financial landscape as a result of financial liberalisation.

D) INVESTMENT OPPORTUNITIES :

There are various schemes available to the investors which are offered by the Government of India, public sector financial institutions, public limited companies, public sector enterprises and other institutions. Most of these investment opportunities are absolutely safe but yield low returns. But in some schemes the over all returns increase as they also provide various tax benefits. The following are the best investment opportunities available to Indian investors.

1. Investment in post office savings bank
2. Schemes offered by Unit Trust of India
3. Schemes offered by Development Banks
4. Schemes offered by P.S.U.S
5. Schemes offered by Mutual funds (Private & Public Sector)
6. Schemes offered by LIC, GIC
7. Investment opportunities in public limited co's
8. Investment in immovable property
9. Investment in gold, bullion, antiques etc.

E) INCREASE IN INVESTMENT RELATED INFORMATION :

The investors now have better information of market conditions to reap more benefit. For

taking a right investment decisions, investors generally need to know the best sources of information. The best sources of information to the intelligent investor is "Financial periodicals, Satellite channels, Global Affairs, National Economic Affairs, Associations, Company Information Quotations, and Publications etc".

When the analysis passes from the stage of description to the higher stage of security selection, the investor's frame of reference widens. The Investment activity now considers not only securities, but security holders as well. The power of selection or rejection of an investment depends upon the forces that will meet the requirements of the mass of investors who make up market. The key to successful investing involves examination and analysis of three chronological segments of the business operations. "Past performance, Present condition, Future prospects".

6.5 NEED FOR INVESTMENT :

Investments are both important and useful in the context of present day conditions. The following factors have made investment decisions increasingly important.

1. Increase in life expectancy
2. Interest rates
3. Increasing rate of taxation
4. Income
5. Inflation
6. Investment channels

1. INCREASE IN LIFE EXPECTANCY :

A tremendous increase in working population, proper planning for life span and longevity have ensured the need for investment decisions. Investment decisions have become significant because working people retire between the age of 55 and 60. The life expectancy has increased due to improved living conditions, medical facilities etc. Savings from the current earnings must be invested in a proper way so that principal and income there on will be adequate to meet expenditure on them after their retirement.

2. INTEREST RATES :

The level of interest rates is another factor for a sound investment plan. Interest rates may vary between one investment to other, risky and non-risky investments. The investor has to decide whether he is getting an acceptable return on the investment commensurate with the risks that are faced by him because stability of interest is as important as receiving a high rate of interest.

3. INCREASING RATE OF TAXATION :

Taxation is one of the crucial factors in a person's savings. Tax planning is an essential part of over all investment planning. If the investment or disinvestment in securities is made without considering the various provisions of the tax laws, the investor may find that most of his profits have been eroded by the payment of taxes. Proper planning could lead to a substantial increase in the amount of tax to be paid. On the other hand good tax planning and investing in tax savings schemes not only reduces the tax payable by the investor but also helps him to save taxes on other incomes. Various tax incentives offered by the government and relevant provisions of the Income Tax Act, the

Wealth Tax Act, are important to an investor in planning investments.

4. INCOME :

Income is also a factor in making a sound investment decision. The general increase in employment opportunities which gave rise to income level and avenues for investment, have lead to the ability and willingness of working population to save and invest such savings.

5. INFLATION :

In the conditions of inflation the prices will rise and purchasing power of rupee will decline. On account of this, the capital is eroded every year to the extent of rise in the inflation. The return on any investment should be regarded as positive. When such return compensates the effect of inflation. For maintaining purchasing power stability, investors should carefully plan and invest their funds by making analysis.

(a) The rate of expected return and inflation rate.

(b) The possibilities of expected gain or loss on their investments and

(c) The limitations imposed by personal and family considerations.

6. INVESTMENT CHANNELS :

The investor in selection of best investments will have to mix between high rate of return oriented and stability of return oriented securities to reap the benefits of both. Various schemes for investments are offered to the public by the Government of India, Public Financial Investitutions, PSUS, Public companies, and Mutual funds. Most of these schemes are absolutely safe investment. But yield low return. However in some schemes the overall return may increase along with providing various tax benefits. There are various schemes designed specifically for retired persons or those who are close to their retirement while others are general schemes aimed at providing investment opportunity to cross section of the public. Thus the distinctive features of each scheme differ from one to other and no particular scheme can be preferred to the others in every circumstance. The schemes that prove most attractive to an individual would depend on his objectives and the different circumstances at any specific time. The growth and development of the country coupled with the policy of liberalisation and globalisation lead to introduction of a vast array of investment outlets.

6.6 INVESTMENT POLICIES OF SCHEDULED COMMERCIAL BANKS :

The latest annual survey on investments of scheduled commercial banks conducted by the Reserve Bank of India relates to march 31-2003. The types of investments covered in the survey are

(i) Central and State Government securities;

(ii) Securities, other than central and state government securities, approved for the purpose of investments under the Indian Trusts Act, 1882;

(iii) Shares, bonds and debentures of Indian joint stock companies;

(iv) Fixed deposits with banks;

(v) Domestic securities which not eligible as trustee securities, such as initial contribution to the Unit Trust of India (UTI), share capital in Regional Rural Banks (RRBs) and

(vi) Foreign securities and other foreign investments. The survey covered all Indian scheduled commercial banks (other than RRBs) operating in India. The RRBs have been excluded from the survey as their investments, as on March 2003, accounted for only 2.1. percent of total investments in India of all scheduled commercial banks. Their investments accounted for only 1.6 percent of total investments in India of all scheduled commercial banks as on 31st March 2002.

6.7 (A) AGGREGATE INVESTMENTS OF SCHEDULED COMMERCIAL BANKS :

Aggregate investment of scheduled commercial banks as on March 31st 2001, 2002 and 2003 presented in table - 1. Total investments of scheduled commercial banks increased by 16.5 percent to Rs. 6,62,251 crore as on March 31st 2003 from Rs. 5,68,346 crore as on March 31st 2002. The share of investments of banks offices in India in total investments of scheduled commercial banks remain very high at around 98% in 2001-2002 and 2003. The investments by foreign offices of Indian banks were mainly in foreign countries' securities and shares and debentures of joint stock companies registered abroad.

Table - 1

Investment of schedule Commercial Banks

(Rs. in Lakhs)
(as at the end of March)

Category	Years		
	2001	2002	2003
I. Investments by Offices in India	4,70,10,237	5,54,66,757	64,769,310
a) Indian Govt. Securities	3,42,93,315	408,76,243	5,02,49,749
b) Other domestic securities Bonds, Shares etc.,	1,27,06,377	1,45,85,648	1,44,05,481
c) Foreign Securities	10,545	4,866	1,14,081
II. Investments by Foreign offices of Indian Banks	10,38,526	13,67,836	14,55,807
Total(I + II)	4,80,48,763	5,68,34,593	6,62,25,117

Source : Various issues of RBI, Bulletins, Mumbai.

Indian Government securities consisting of Central Government securities, State Government securities and others including postal saving deposit certificates and postal obligations, accounted for 75.9 percent of total investments of banks as on March 31, 2003 as against 71.9 percent as on March 31, 2002. Indian Government securities were Rs. 3,42,933 crores as on March 2001. Thus it appears there is a clear preference for Indian Government securities especially Central Government securities, in the investment choice of the banks in India. Other domestic securities formed 26.4 percent, 25.7 percent and 21.8 percent of the total investment of the banks as on March 31st 2001, 2002 and 2003 respectively.

Investments in Central Government securities increased from Rs. 2,89,634 crore as on 31st March 2001 to Rs. 4,23,890 crore as on March 2003, indicating a higher growth of 22.5 percent during 2002-03 as compared to the growth of 19.2 percent during 2001-02. The net increase of Rs. 77,768 crore in investments in Central Government securities indicated continued investment dominance of banks for this category of securities, as it constituted 82.8 percent of the net increase investments of the banks. Banks' investments in State Government securities also grew at a very high rate of 25.2 percent from Rs. 62,723 crore as on March 31, 2002 to Rs. 78,505 crore as on March 31, 2003.

The investments of scheduled commercial banks in other domestic securities comprise shares and debentures of joint stock companies, trustee securities, fixed deposits, units of UTI, Certificate of Deposits (CD), Commercial Paper (CP), mutual funds, initial contribution to share capital of UTI, bonds and debentures of quasi-government bodies, venture capital funds etc banks' investments in these domestic securities amounted to Rs. 1,44,055 crore as on March 31, 2003 as against Rs. 1,45,856 crore as on March 31, 2002. The investments in shares and debentures of joint stock companies increased by a lower rate of 5.5 percent than the growth of 22.8 percent recorded in the previous year. These investments amounting to Rs. 1,03,470 crore accounted for 15.6 percent of the total investments as on March 31, 2003. Banks' outstanding investments in other trustee securities declined further by 12.9 percent from Rs. 23,329 crore in March 2002 to Rs. 20,314 crore in March 2003. In contrast, investments in units of UTI and other mutual funds increased noticeably during 2002-03. Investments in the certificate of deposits and commercial papers have registered a substantial decline of 56.1 percent from Rs. 6,693 crore as on March, 2002 to Rs. 2,940 crore as on March 31, 2003. This reflected, in part, a fall in primary issuances by manufacturing companies having access to sub PLR lending etc. Other investments comprising bonds and debentures of quasi-government bodies, venture capital funds, etc., also registered a significant fall in 2003 as against a marginal rise in 2002. Banks' investments in fixed deposits of Rs. 2,705 crore forming 0.4 percent of the total investments as on March 31, 2003, has shown a substantial decline of 16.1 percent, in contrast to a large increase of 53.2 percent in the previous year.

6.8 BANK GROUP-WISE INVESTMENTS OF SCHEDULED COMMERCIAL BANKS :

The investments of scheduled commercial banks classified by type of securities across major banks groups are presented in Table 2. The nationalised banks' group accounted for the highest share of 45.9 percent in the total outstanding investments of Rs. 5,68,346 crore made by scheduled commercial banks follows by State Bank of India and its associates at 31.6 percent as on March 31, 2002. The nationalised banks group accounted for the highest share of 46.9 percent in the total outstanding investment of Rs. 6,62,251 crore as on March 31, 2003.

The shares of other scheduled commercial banks and foreign banks were 15.2 percent and 5.8 percent, respectively. The shares of different bank groups in total outstanding investments as on March, 31, 2003 were marginally different from those observed for the previous year.

Central Government securities constituted the major part (73.0 percent) of investments made by State Bank of India and its Associates as on March 31, 2003. They were followed by investments in State Government securities (12.6 percent), shares and debentures of joint stock companies (7.9 percent), other trustee securities (2.9 percent) and other domestic securities (1.5 percent). Investments

made by foreign offices of State Bank of India and its Associates stood at Rs. 4,291 crore, accounting for 2.0 percent of total investments of this bank group. Total investments of State Bank of India and its Associates increased by 18.5 percent from Rs. 1,79,393 crore as on March 31, 2002 to Rs. 2,12,632 crore as on March 31, 2003. The outstanding investments of State Bank of India and its Associates in Central government securities increased by a higher rate of 22.1 percent to Rs. 1,55,307 crore in 2003 over the level in 2002, those in State Government securities increased by a much higher rate of 43.5 percent to Rs. 26,704 crore, while the investments in other trustee securities declined by 10.4 percent to Rs. 6,215 crore in 2003. Investments of foreign offices of State Bank of India and its Associates declined by 7.8 percent from Rs. 4,652 crore to Rs. 4,291 crore during the same period.

As compared with State Bank of India and its Associates, Central Government securities accounted for 56.6 percent of total investments of Nationalised Banks which stood at Rs. 3,10,618 crore as on March 31, 2003. Shares and debentures of joint stock companies formed 16.6 percent of their total investments, followed by State Government securities at 15.7 percent and other trustee securities at 4.1 percent. The share of Central Government securities, however, registered an increase from 53.8 percent in 2002 to 56.6 percent in 2003. This bank group's holdings in State Government securities increased from Rs. 40,966 crore to Rs. 48,909 crore during the same period. Investments (market value) in shares and debentures of joint stock companies increased further by 16.6 percent to Rs. 51,702 crore during 2002-03 on top of the increase of 31.5 percent during 2001-02. Investments made by foreign offices of Nationalised Banks also increased at a higher rate of 14.7 percent to Rs. 10,267 crore.

Investments, made by 'Other Scheduled Commercial Banks' increased at a relatively low rate of 5.8 percent to Rs. 1,00,569 crore as on March 31, 2003 from Rs. 95,097 crore as on March 31, 2002. While investments in Central Government securities of 'Other Scheduled Commercial Banks' increased by 14.3 percent to Rs. 64,415 crore, their investments in other portfolios mostly declined by end of March 2003. In particular, the investments in 'other trustee securities' declined sharply by 46.4 percent to Rs. 1,234 crore as on March 31, 2003 from Rs. 2,301 crore as on March 31,2002. The composition of investments of this bank group as on March 31, 2003 indicated that Central Government securities accounted for the largest share (64.1 percent), followed by shares and debentures of joint stock companies (25.4 percent) and other domestic securities (6.4 percent).

Investment pattern of Foreign Banks indicated that investments in central government securities and in shares and debentures of joint stock companies together accounted for 98.0 percent of their total investments as on March 31, 2003. The growth pattern of investments of Foreign Banks during 2002-03 was similar to that of other Scheduled Commercial Banks. While the investments in Central Government securities increased by 27.2 percent to Rs. 28,329 crore, their investments in State Government securities, other trustee securities and other domestic securities declined by 26.5 percent, 31.8 percent and 53.9 percent, respectively, during 2002-2003. Foreign Banks' investments in shares and debentures of joint stock companies remained stable at Rs. 9,331 crore in 2002 and 2003.

BANK GROUP-WISE INVESTMENTS IN OTHER TRUSTEE SECURITIES :

Investments of scheduled commercial banks in other trustee securities cover their investments in major all-India bodies like Industrial Development Bank of India (IDBI), State Electricity Boards (SEBs), State Financial Corporations (SFCs), Industrial Finance Corporation of India (IFCI), etc., and

these details according to bank groups are presented in the following paragraph.

Investments in IDBI, SEBs and SFCs topped in the investment portfolio of all scheduled commercial banks, with respective shares at 17.5 percent, 17.1 percent, 17.0 percent as on March 31, 2003. The investment portfolio of State Bank of India and its Associates indicated that SEBs accounted for 29.1 percent of other trustee securities, followed by IDBI at 18.1 percent and SFCs at 13.6 percent. In the case of Nationalised Banks, investments in State Financial Corporations accounted for the largest share (18.3 percent). In the case of Other Scheduled Commercial Banks, securities of State Financial corporations accounted for the largest share at 23.5 percent of other trustee securities. In the case of Foreign Banks, securities of IDBI held the largest share of 20.3 percent of the investments in other trustee securities. Securities of SFCs, SEBs, IFCI and IDBI together accounted for 60.8 percent of investments in other trustee securities held by SCBs as on March 31, 2003.

6.8.1 BANK GROUP-WISE PATTERN OF INVESTMENTS IN THE INSTRUMENTS OF CAPITAL MARKET :

Instruments of capital market comprise shares and debentures of joint stock companies, units of UTI and other mutual funds, initial contribution to share capital of UTI, CDs, CPs and shares of DICGC. Investments of scheduled commercial banks in these instruments increased from Rs. 1,22,528 crore as on March 31, 2002 to Rs.1,23,741 crore as on March 31, 2003 registering a marginal growth of around 1 percent during 2002-03. Major portion of this category of investments was in the form of debentures of joint stock companies; market value of which increased from Rs. 89,569 crore as on March 31, 2002 to Rs. 94,639 crore as on March 31, 2003. Investments of banks in shares of joint stock companies also increased from Rs. 8,499 crore to Rs. 8,831 crore during the same period. The scheduled commercial banks' investments in the units of UTI and other mutual funds declined from Rs. 24,460 crore in 2002 to Rs. 20,271 crore in 2003.

Bank group-wise investments in instruments of capital market as on March 31, 2003 indicated that the Nationalised Banks accounted for the largest share of 50.0 percent, registering an increase in the share from 46.2 percent in 2002. The share of other Scheduled Commercial Banks decreased to 25.8 percent as on March 31, 2003 from 27.2 percent as on March 31, 2002. The State Bank of India and its Associates and Foreign Banks also had lower shares at 16.3 percent (18.2 percent in 2002) and at 7.9 percent (8.5 percent in 2002), respectively. It is observed that all bank groups continued to show preference for debentures over shares. The debentures (market value) formed 91.5 percent of the total investments made by banks in shares and debentures. In respect of debentures and equity shares in joint stock companies, the share of investments of State Bank of India and its Associates in debentures declined marginally from 91.9 percent as on March 31, 2002 to 91.4 percent as on March 31, 2003. Proportion of investments in debentures, in the case of Nationalised Banks, increased from 91.5 percent to 93.0 percent and that in the case of 'Other Scheduled Commercial Banks' and Foreign Banks declined from 88.5 percent to 86.7 percent and from 97.4 percent to 96.2 percent, respectively.

6.8.2 BANK GROUP-WISE INVESTMENTS IN PUBLIC SECTOR ENTERPRISES :

Investments of Scheduled Commercial Banks in bonds of public sector enterprises increased

by 2.3 percent from Rs. 17,246 crore as on March 31, 2002 to Rs. 17,642 crore as on March 31, 2003. As regards their composition, banks invested about 32.0 percent of these bonds in Rural Electrification Corporation (REC), followed by Housing and Urban Development Corporation (HUDCO) (18.2 percent), Power Finance Corporation (15.3 percent), Railway Bonds (11.3 percent) and Nuclear Banks' holdings in such securities increased from Rs. 9,010 crore as on March 31, 2002 to Rs. 9,732 crore as on March 31, 2003. In the case of State Bank of India and its Associates, and other Scheduled Commercial Banks, investments in these bonds decreased from Rs. 3,662 crore to Rs. 2,866 crore and from Rs. 4,056 crore to Rs. 3,782 crore, respectively.

6.8.3 INVESTMENTS IN CENTRAL AND STATE GOVERNMENT SECURITIES (EXCLUDING TREASURY BILLS, POSTAL OBLIGATIONS, ETC.) - ACCORDING TO INTEREST RATE AND BANK GROUPS :-

The distribution of banks' investments in Central and State Government loans according to different interest (coupon) rate classes, as on March 31, 2003 is presented here. The proportion of banks' holdings of Central Government securities with high interest rates (11 percent and above) decreased significantly from 72.5 percent as on March 31, 2002 to 58.3 percent as on March 31, 2003. Among these, securities with interest rate '12 per cent and above' accounted for 24.9 percent of banks' holdings in Central Government securities in 2002, which decreased to 19.6 percent in 2003. Despite a declining trend, the securities with interest rate of '11 percent to 12 percent' accounted for major share of 38.7 percent in 2003. The share of securities, held by banks, with interest rate of '6 percent to 8 percent' increased from 3.7 percent to 15.7 percent during the years 2002 and 2003.

Similar trend was observed in respect of banks' holdings in State Government securities. The proportions of State Government securities in the interest rate changes '12 percent and above' and '11 percent to 12 percent' decreased from 51.9 percent to 40.8 percent and from 20.0 percent to 13.6 percent, respectively during 2002-2003. The proportion of banks' holdings in State Government securities with interest rate of '8 percent to 11 percent' also decreased from 28.1 percent to 22.0 percent during 2002-2003. The share of State Government securities held by Banks, which had coupon rate of less than 8 percent, went up substantially to 23.6 percent during 2002-2003.

State Bank of India and its Associates' holdings of Central Government securities with interest rate of '11 per cent to 12 percent' accounted for 54.4 percent in 2003 (as against 65.5 percent in 2002) and those with interest rate of '12 percent and above' accounted for 17.9 percent (as against 22.7 percent in 2002) of their total holdings in Central Government securities as on March 31, 2003. Of the total Central Government securities held by Nationalised Banks, 33.2 percent, 25.7 percent and 21.5 percent of total holdings of these securities were in the interest rate ranges of '8 to 11 percent', '11 to 12 percent' and '12 percent and above', respectively. In respect of Foreign Banks, such securities with the interest rate of '11 to 12 percent' accounted for 54.4 percent of their investments in Central Government securities.

In the case of State Government securities held by each bank group, major portion of the holdings was with interest rate of '12 percent and above'. Foreign banks recorded the highest share of 62.7 percent holdings in State Government securities with interest rate of '12 percent and above'. In the case of State Bank of India and its Associates, 32.0 percent of their investments in these

securities was in the interest rate range of below 8 percent.

6.8.4 CLASSIFICATION OF INVESTMENT PORTFOLIO OF BANKS INTO HTM, AFS AND HFT CATEGORIES BY BANK GROUPS :-

Commercial banks' investments in different types of securities, as on March 31, 2003, are classified into three categories, viz., HTM, AFS and HFT for each of the four banks groups. The pattern of holdings under these categories was more or less similar for all bank groups. Holdings in HTM category were in the range of 13.1 to 16.1 percent in respect of Foreign Banks and State Bank of India and its Associates, while the share was in the range of 23 percent to 24.6 percent for other two groups of banks. About 72-76 percent of the investments were classified as securities 'available for sale'.

6.9 INVESTMENTS OF SCHEDULED COMMERCIAL BANKS IN STATE-LEVEL SECURITIES :-

The State-wise investments of Scheduled Commercial Banks in various State-level securities as on March 31, 2002 and 2003 are presented here State-level securities consists of securities floated by the State Governments, bonds of State-level bodies share capital of RRBs and debentures of co-operative institutions. Majority of such investments were in State Government securities, which accounted for 85.6 percent (77.4 percent as on March 31, 2002) of the total amount of State-level securities as on March 31, 2003. Other important State-level securities in which banks invested, were State Electricity Boards (SEBs) (4.6 per cent), Government and Quasi-Government Bodies (4.6 percent) and State Financial Corporations (SFCs) (2.9 percent), Banks' investments in six states, viz., Uttar Pradesh, Andhra Pradesh, West Bengal, Rajasthan, Maharashtra and Tamil Nadu accounted for 52.6 percent of their investments in various State-level securities.

State-wise investments of banks as on March 31, 2003 in the State Government securities was the highest in Uttar Pradesh (Rs. 11,890 crore), followed by Andhra Pradesh (Rs. 7,834 crore), Rajasthan (6,308 crore), West Bengal (Rs. 5,925 crore), Bihar (Rs. 5,306 crore), Tamil Nadu (Rs. 4,685 crore) and Orissa (Rs. 4,382 crore). The Scheduled Commercial Banks invested Rs. 4,254 crore in the bonds of SEBs as on March 31, 2003. Investments of banks in the bonds of SEBs as on March 31, 2003, were the highest in Madhya Pradesh (Rs. 844 crore), followed by Maharashtra (Rs. 687 crore), Tamil Nadu (Rs. 546 crore), Punjab (Rs. 529 crore) and Rajasthan (Rs. 478 crore), Banks' investments in SFCs amounted to Rs. 2,660 crore as on March 31, 2003 and these investments were the highest in Uttar Pradesh (Rs. 566 crore), followed by Karnataka (Rs. 426 crore), Orissa (Rs. 290 crore), and Madhya Pradesh (Rs. 245 crore). Banks' investments in securities of State Industrial Development Corporation (SIDCs) amounted to Rs. 890 crore as on March 31, 2003. Of this amount, investments in Tamil Nadu (Rs. 432 crore) were found to be highest, followed by Maharashtra (Rs. 110 crore) and Rajasthan (Rs. 76 crore). Banks' investments in the bonds of Housing Boards, Municipal Corporations, Municipalities and Port Trusts together amounted to Rs. 415 crore and related to only a few states.

Scheduled Commercial Banks' investments in interest-bearing State loans as on March 31, 2002 and 2003 are also presented here. Of the total outstanding state loans of Rs. 1,33,090 crore, Six states, viz., Uttar Pradesh, Andhra Pradesh, Rajasthan, West Bengal, Tamil Nadu and Bihar

together accounted for more than 50 per cent. Proportion (absorption rate) of Investments of scheduled commercial banks, at the aggregate level, constituted 59.0 percent of the total outstanding amount of interest-bearing state loans as at end March 2003. Besides Arunachal Pradesh (at 90.8 percent), the absorption rates of banks remained high in the newly formed states. It was the highest in Jharkhand (75.4 percent) followed by Chhattisgarh (71.9 percent) and Uttaranchal (70.0 percent). Of the remaining states, the absorption rates of banks were above 60 percent in nine states, Viz., Haryana (64.5 percent), Rajasthan (64.3 percent each), West Bengal (63.8 percent), Goa (63.9 percent), Orissa (63.7 percent), Bihar (62.2 percent), Uttar Pradesh (62.0 percent), Madhya Pradesh (61.0 percent) and Manipur 62.0 percent. Absorption rate of the banks in the interest bearing state loans was below 50 percent in respect of Maharashtra only. Bank group-wise pattern of investments in the State Government securities and State-level bodies for the years 2002 and 2003 are as follows. Of the total investments of Rs. 91,705 crore in State-level securities as on March 31, 2003, the Nationalised Banks accounted for the highest share at 63.5 percent, followed by State Bank of India and its Associates at 31.7 percent and Other Scheduled Commercial Banks at 4.8 percent.

Considering banks' investments in State-level securities in North - Eastern States, State Bank of India and its Associates accounted for the highest share among all bank groups. These banks contributed 65.3 percent in Mizoram, 57.4 percent in Nagaland, 53.5 percent in Sikkim, and 54.1 percent in Manipur. Nationalised banks' share in total investments in State-level securities was more than 70 percent in the states of Delhi, West Bengal and Punjab. Other Scheduled Commercial Banks accounted for more than 10 percent in the State-level securities for the States of Kerala, Jammu and Kashmir, Tamil Nadu, Karnataka and Maharashtra. Investments of Foreign Banks were negligible in the state-level securities, except for a few states like Maharashtra, Gujarat and Karnataka.

6.10 MAJOR RECENT POLICY DEVELOPMENTS RELATING TO BANKS' INVESTMENTS :

1. Banks may shift investments to/from 'held to maturity' category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year. Banks may shifting investments from 'available for sale' category to 'held for trading' category with the approval of their Board of Directors/Asset-Liability Committee (ALCO)/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of directors/ALCO. shifting of investments from 'held for trading' category to 'available for sale' category is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming undirectional. Such transfer is permitted only with the approval of the Board of Directors/ALCO/Investment Committee. Transfer of scrips from one category to another, under all circumstances, should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for.
2. Banks were advised to Compute Investment Fluctuation Reserve (IFR) with reference to

investments in two categories, viz., 'held for trading' and 'available for sale' and not to include investments under 'held to maturity' for this purpose.

3. It was decided to introduce trading in Government Securities through a nation wide anonymous, order driven, screen based trading system of the stock exchanges, in the same manner in which trading takes place in equities. This facility of trading of government securities on the stock exchanges would be available to banks in addition to the present Negotiated Dealing System (NDS) of the Reserve Bank, which will continue to remain in place. Accordingly, with effect from January 16, 2003, trading of dated Government of India (GOI) securities in dematerialised from was permitted on automated order-driven system of the National Stock Exchange (NSE), The Stock Exchange, Mumbai (BSE) and Over-The-Counter Exchange of India (OTCEI). It was decided that the scheme will subsequently be extended to GOI treasury bills and State Government Securities.

4. The final guidelines on Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 was issued. The guidelines and directions provide for different aspects of asset reconstruction and securitisation relating to registration, owned fund, permissible business, operational structure for giving effect to the business of securitisation and asset reconstruction, deployment of surplus funds, internal control system, prudential norms, disclosure requirements, etc., so as to facilitate the smooth formation and functioning of securitisation companies and reconstruction companies. In addition to the guidelines and directions, which are mandatory, the Reserve Bank also issued guidance notes of recommendatory nature covering aspects relating to acquisition of assets, issue of security receipts, etc., A set of standard guidelines in the matter of takeover of the management, sale or lease of whole or part of the business of the borrower is being formulated.

5. To give further relaxation in building IFR it was decided that effective from March 31, 2003 onwards, while IFR would continue to be treated as Tier II capital, it would not be subject to the ceiling of 1.25 percent of the total risk weighted assets. However, for the purpose of complain with the capital adequacy norms, Tier II capital including IFR would be considered upto a maximum of 100 percent of total Tier I capital.

6. Banks were exempt from the requirement of appropriating the profit on sale of securities from 'held to maturity' (HTM) category to "Capital Reserve Account". As a one time measure. This exemption will be applicable only in respect of the identified securities, which are sold to the Government of India under the scheme of Government of India's Debt Buyback Programme.

6.11 CAPITAL ADEQUACY NORMS - RECOMMENDATIONS OF NARASIMHAM COMMITTEE :

The systematic risk posed by the failure of banks and the need to provide safety net by the society has been an issue that received its due attention at the international level for a long time. The enactment of Glass Steagal Act, 1932 in the USA was made basically to insulate the banking system from other branches of financial activities. In India also, the Indian Companies Act was amended number of times with a view to vest RBI with adequate power to regulate and stabilise the banking system which ultimately culminated in the enactment of Banking Regulation Act, 1949.

The RBI Act, 1934 incorporating section 42 along with BR Act, 1949 served the economy well by ensuring a stable financial system. In the year 1969, the Government nationalised 14 major banks

and subsequently in 1980, another six banks were nationalised. Thus, 20 were nationalised. The State Bank of India (nationalised in 1956) and its Associates and other nationalised commercial banks constituted more than 90 percent of the total deposits of the banking system in the decade of eighties. With a view to protecting the interest of depositors, Deposit Insurance and Credit Guarantee Corporation was also constituted.

Ensuring the safety and stability of the financial system through capital adequacy norms was evolved by the international banking system especially after sovereign default committed by some of the South America countries like Mexico, Argentina, Chile, etc. The capital adequacy norm as a measure to protect the banking system's vulnerability was thought of (by the OECD countries) initially for introduction in the internationally active banks in their respective countries.

With a view to implementing international best practices as was evolved by the Basle Committee, Narasimham Committee on Financial Sector Reforms recommended that Indian banks should adhere to income recognition, asset classification, provisioning and capital adequacy norms. Capital adequacy norms were prescribed initially at the lower level of 4 percent and gradually increased to 9 percent at present.

In the meantime, Narasimham Committee on Banking Sector Reform, also known as Narasimham Committee (II) recommended the need for putting in place an appropriate risk management system. However, the science of risk management and practice underwent significant changes thanks to JP Morgan model of VaR as an important tool to measure the market risk. In deference to the above, and also other developments, the original Accord of 1988 underwent a number of amendments, the most prominent of them was the amendment made in respect of treatment of market risk which gave more freedom to banks to evolve their own model to assess the market risk.

Further, a number of in adequacies and problems are noticed in the provisions of the capital Accord of 1988 which either lost its effectiveness over a period of time or allowed banks to indulge in what is known as Regulatory Arbitrage. The literature in this regard enumerates the following :

'One size fits all' approach adopted the 1988 Accord is bound to become inappropriate to the differing country specific situations and also due to the varying requirement and role of the financial system.

"The broad brush" approach in respect of clubbing all the corporate borrowing in the bucket of hundred percent is inappropriate. Obviously, the riskiness of BB rated borrower is very different from that of the 'AAA' rated borrowers. This is also true for investment in securities backed by sovereign guarantee or the inter - bank borrowing.

Taking into account the difficulties in evolving rule based approach to suit all the country specific situations, the efforts are on at the international level to move towards evolving system - based approaches. It involves identifying appropriate systems and practices already prevalent in different countries and evolving them to suit the international financial architecture which would ensure the safety and security of the financial system.

The decade of 90's is known for the rapid technological advancement in the information and communication technology. It was accompanied by the proliferation of financial and derivative instruments. The above developments led to tremendous increase in the business volume along

with reduction in transaction cost for the financial system. Hence, the size and the quality of the balance sheet of the banking system underwent changes beyond recognition while at the same time exposing individual banks to myriad types of risk hitherto unrecognised. Further, it raised the level of concern of the monetary and supervisory authorities about the safety and stability of the financial system. Due to the emergence of new genre of instruments in the form of derivatives and securitised transactions, the risks posed by the off-balance sheet items of banks also became a matter of concern. Hence, the original accord became obsolete in the changed situation.

Another important development is the blurring of distinction between banks and other financial intermediaries. Banks started entering into other territories hitherto reserved for other intermediaries like merchant banks and security traders. Banks offering all types of financial services under one roof are known as 'financial super markets' or 'universal banking'. Hence, the profile of risk faced by banks changed beyond recognition as the risks posed by undertaking such activities may spillover and threaten the viability of otherwise sound banks. The capital adequacy norms of 1988 Accord which gave explicit recognition only to the credit risk would not serve the purpose in the changed situation.

Taking advantage of the broad-brush approach, some banks indulged in 'Regulatory Capital Arbitrage' by moving down in the ladder of quality borrowers/investments in the asset portfolio. This process also came to be known as 'Cherry picking'.

In the early 1990s, US banks shifted sharply from corporate lending to government securities. This may be partly attributed to post Basle Accord System of capital requirements.

Due to the above developments, the original Capital Accord of 1988 is undergoing drastic changes in the New Capital Accord which will be finalised in 2003 and sought to be implemented by the end of 2006.

The revised Capital Accord has shifted its emphasis from capital adequacy to other instruments like supervision and market discipline. Hence, the revised Capital Accord has adopted a three-pillar approach to achieve the objective of ensuring the safety and stability of the financial system. The three pillar approach is based on capital adequacy, supervisory oversight and market discipline.

Capital Adequacy Norm to reflect all types of risks embedded in the balance-sheet and evolving a framework to arrive at what is known as 'economic capital' different from the regulatory capital to reflect more closely the risk embedded in the balance-sheet.

Supervisory Oversight to ensure that banks are putting in place appropriate risk management system and establish best practices in line with the international best practices.

Market Discipline is achieved through adherence to the transparency in the matter of viability, profitability, quality of assets, adoption of corporate governance principles. This is basically to allow the market particulars to assess the different market players on the basis of merit and enable them to distinguish the good from bad. This is important especially to avoid 'herd behaviour' on the part of investors especially when there is a financial crisis experienced by one or two market players. It is found that opaqueness leads to the 'herd behaviour' on the part of investors.

6.11.1 CREDIT CRUNCH HYPOTHESIS :

An important issue that might crop up within the macro-economic perspective is that whether the shift in the preference of banks from lending to investment in the government sector has led to credit crunch for the commercial sector inducing in the process a loss of potential output for the economy as a whole.

6.11.2 SUPERVISORY OVERSIGHT AND THE CHANGE IN THE BEHAVIOUR OF BANKS:

When the regulators prescribe capital charge on the RWA and of the capital adequacy is just above the prescribed level, then it brings sufficient pressure on banks to increase the level of capital so that the concerned bank does not fall short of the necessary capital a given size of assets portfolio. The response of banks differ under varying circumstances. The options available to banks to raise capital is partly determined by the external environment within which the banks operate which may be summarised as follows :
Practices in line with the international best practices.

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The state of the economy with reference to the trade cycle.

The vibrancy of the capital market to enable the banks to raise both Tier I and Tier II capital in the market.

The rate of interest prevailing in the market and its association with international rate movements.

The government stance and policy guidelines.

IMPACT ON THE INDIAN BANKING SYSTEM :

The implementation of the capital adequacy norms with its concomitant risk management system has brought about sea change in the Indian banking system. The implication may be summarised as follows :

The capital adequacy norm prescribed for banks resulted in increase in the capital stock of the banking system over a period of time. It was gradually increased from 4 percent to 9 percent at present. Indian Banks, as on end-March 2002, are estimated to possess around 11.8 percent of the RWA, significantly above the regulatory requirement.

All banks have put in place the machinery for risk management. It had created a new sense of awareness about the importance of risk management in the realm of banking.

The level of NPA which were earlier not recognised by banks explicitly, is now being required to reveal in the Balance Sheet. Further, it has emerged as the yardstick of performance of individual banks and its viability.

The pressure created by the disclosure of NPA has given rise to awakening in respect of the need for legal reform to tackle the meance of NPA in an effective manner.

Through SLR requirement have been reduced to the statutory level of 25 percent, still the investment of banks in Government and other approved securities is to the extent of 37 percent on commercial consideration. This may be partly attributed to zero capital requirements for investment in Government securities. The desire to contain the level of NPA at a lower level may be cited as another reason.

The government has recapitalised PSBs to the extent of Rs. 20,000 crore.

The government has committed to reduce its stake in the nationalized banks to the minimum of 33 percent, so that banks may be subjected to corporate governance principles at an early stage.

6.12 QUESTIONS :

1. Define the term ‘investment’. Explain the nature of investment.
2. What are the factors influencing for investment?
3. Explain the investment policies of scheduled Commercial Banks in India.
4. What are the major policy developments relating to banks investments?
5. Explain the capital adequacy Norms recommended by Narasimham committee for ensuring the safety and security of the financial system in India.

6.13 FURTHER READINGS :

1. “Investment Management” - V. Gangadhar and G. Ramesh Babu
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2. “Commercial Bank Financial Management” - Joseph. F. Sinkev Jr. New York
   Macmillan Publishing INC, 1983.
3. Role of Commercial Banks in India’s developing economy - B.P. Sharma
4. Reserve Bank of India Bulletin, Reserve Bank of India, Mumbai - March 2004.
5. Reserve Bank of India Bulletin, Reserve Bank of India, Mumbai - February - 2003.
6. Various issues of Report on Trend and Progress of Banking in India - RBI, Mumbai.

Lesson - 7

DIFFERENT TYPES OF LENDING - LENDING TO INDUSTRY AND TRADE

OBJECTIVES :

- to know the general principles of sound lending
- to understand the various forms of Advances
- to know the principles of good bank lending
- to examine different modes of creating charge
- to outline on the advances against various collateral securities
- to explain the cash credit system and presenting the Chore Panel's Recommendations.

STRUCTURE :

7.1 Introduction
7.2 General Principles of Sound Lending
7.3 Forms of Advances
7.4 Classification of Loans and Advances
7.5 Canons of a Good Banking Security
7.6 General Principles of Secured Advances
7.7 Modes of creating a charge of security
- **7.7.1 Pledge**
- **7.7.2 Mortgage**
- **7.7.3 Hypothecation**

7.8 Advances against collateral securities
- **7.8.1 Advances against goods**
- **7.8.2 Documents of Title to goods**
- **7.8.3 Life Insurance Policies**
- **7.8.4 Stock Exchange Securities**
- **7.8.5 Supply Bills**

7.9 Cash Credit System - Chore Panel's Recommendations
7.10 Key words
7.11 Self - Assessment Questions

7.1 INTRODUCTION :

The main business of a Commercial Bank is to receive deposits and lend money. Receiving deposits involves no risk, since it is the banker who owes a duty to repay the deposit, whenever it is demanded. On the other hand, lending always involves much risk because there is no certainty of repayment. But, a banker earns a bulk of his income only through lending. The granting of advances

is one of the most important functions of a bank. It's strength depends cosiderably on the quality of its advances and the proportion they bear to the total deposits.

A banker should be very cautious in lending because, he is not lending money out of his own capital. A major portion of the money lent comes from the deposits received from the public. These deposits are mostly repayable on demand. While granting loans and advances, the banker is always keen to secure himself by some reliable and tangible securities. However, clean advances are also considered to customers having honesty and capacity to manage the business of venture for which the clean facility is sought.

7.2 GENERAL PRINCIPLES OF SOUND LENDING :

While lending money, a banker has to follow a very cautions policy and he must take into account the following general principles of sound lending.

1) SAFETY :

'Safety first' should be the guiding principle to be followed in granting loans and advances. Since banks deal with the money of their customers, they have to ensure the safety of the funds lent. Safety means that the borrowers should be in a position to repay the loans borrowed with interest as and when they are due. The repayment of borrowers in turn depends on (1) their capacity to repay (2) their willingness to repay and (3) collateral security offered. The capacity of a borrower depends upon the success of his venture. The willingness depends upon his honesty and integrity. Hence, before lending money, the banker should ascertain whether the borrower is a person of a good character and integrity and whether the security offered is adequate and easily realisable.

2) LIQUIDITY :

Liquidity is nothing but the ability of a banker to convert as asset into cash readily without much loss in its value. In other words, a bank has to maintain a liquid position so that, he can meet the demands of his customers at any time. Money granted for lond periods are less liquid because they cannot be received back in times of need. Liquidity also depends on the type of the asset a banker selects, while granting loans and advances. It is aptly said, 'a prudent banker is one who knows the distinction between a bill and a mortagage' it is so because, a mortgage is a long term loan. Creation of a mortgage involves much formalities and expenses. Moreever, a mortgage cannot be converted into cash readily. A mortgage is always created against immovable assets and hence, they are very difficult to realise. On the other hand, a bill is purely a short term one. It will not be dishonoured normally. In times of need, it can be converted into cash immediately by rediscounting it with the central bank. Hence, the principle of liquidity demands that a banker should confine his lending to short term, against assets which can be converted into cash immediately.

3) PROFITABILITY :

Commercial banks also exist for earning profit. A banker cannot run the banking business without profit. Profit is essential to meet the day to day expenses to pay interest on deposits, to meet the salaries of staff etc., Profitability demands that a banker should employ all funds to earn maximum profits. But liquidity demands that the banker should maintain a large cash reserve to meet the demands of customers. Thus, these two principles are opposing to each other. In fact, an

experienced banker knows that these two opposing factors must meet with each other at a point called safety. Hence, safety and liquidity should not be sacrified for profitability.

4) SECURITY :

Security is an insurance to fall back upon in case of an emergency. It will not be waived where it is available unless it is a case of advance made to the certain sections of society in the economy. Further, as the funds belong to the depositors, they can not be risked by making clean advances without security to one and all. Securities wherever available are also taken because, if they are left out, there are chances that the borrower may raise funds else where by charging them to others so that to that extent, the banker's position is jeopardised. Therefore, to minimise risk, security should be inserted upon. The security must be adequate, easily realisable and free from encumberances.

5) PURPOSE OF LOAN :

Another important canon of lending is that the purpose of the loan must be enquired into by the banker. Repayment of loans mainly depends upon the purpose for which loans are needed. For instance, loans for productive purposes would enhance the earning capacity of the borrower, and thus, it would pave way for easy repayment. Loans for unproductive purposes, hoarding, black marketing, social cermonies etc., are risky, since there is no guarantee of repayment. So, they are not entertained. After nationalisation of banks, the purpose of the loan is given more weightage than the security offered for the loan.

6) DIVERSIFICATION :

As there is risk in every advanced, it is always necessary that banks should spread the risk by broadfasing their advances by lending to a large number of borrowers instead of comfining their advances to a few by making large advances. A banker would not concentrate all his loanable funds in one industry or one particular area or a group of few customers only. If he does so, his very survival is questionable. Particularly, when a particular industry fails, or when there is an adverse change in one place etc. This is in accordance with the maximum "Donot lay all eggs in the same basket". For diversification of risk in advances, a wide network of branches will be an aded advantage because, as reasons differ in the country, greater use of the funds is possible the whole year round with the help of branches situated at various parts of the country.

7) ASSURED REPAYMENT :

A banker should come forward to lend only when the repayment is assured. When there is difficult in repayment, a banker's ability to create further credit is affected. Hence, while advancing money, he should see the source of repayment. For example, loans against a FDR which is going mature shortly a LIC policy which is going to mature soon, a debanture which is to be redeerned shortly etc., are considered as sound loans. Thus, a sound and safe credit is one, where timely repayment is assured.

8) INTEGRITY AND RELIABILITY OF THE BORROWER :

To avoid bad debts, the borrower's reliability is the basic factor before any loan proposal is considered. The whole success of the lending will usually depend upon the true representation of

the facts by the customer and on his ability to carry through any scheme to a satisfactory conclusion. The study of a borrower involves the canons of three 'Cs' of the party i.e., his character, capacity and capible. If the borrower lacks business integrity and rarely disciplines himself to repay the debts, he is said to be lacking in good character. Business morality may also be affected if the borrower lives beyond his means and is a victim of vices. Always circumstances make a man. A borrower may be good today. Under altered conditions, he may change. A person who is really honest will rarely change whatever be the testing factors. His ditermination to be honest and willingness to repay when possible will remain steadbastly like a rock. This aspect is the good part of the security for any bank advance.

The capacity of a borrower refers to his ability to run the show in a possible manner. It refers to the methods which he has the capacity to use in the business. It also refers to his credembials and experience in his line of business. Another aspect deals with the capital of the borrower. The borrower must have his own state in the business i.e., he must take a part of the risk in the business. This is to be done by putting his own money into the business. That creates a sense of involvement in the business in the minds of the borrowers.

9) SOCIAL OBJECTIVES :

While making advances, the banker should give the highest priority to the national interest. Today, banks have a strong, social objective and social conscience. It is the responsibility of each and every bank to ensure that the bank credit flows smoothly to the neglected sectors of the economy and to the under privileged sectors of the society. Towards this end of view, banks have given up their 'security oriented lending' and have taken up the 'need based loans' or 'productivity of the loan'. The liability of a project is given more weight than the security behind a loan.

10) LAW OF LIMITATION ACT :

A lending banker should also fear in mind the law of limitation act. According to this act, a debt will become a bad one after the expiry of 3 years from the date of the loan. It is applicable to loans and advances granted by banks. Hence, each and every banker should be very careful in renewing the loan, year after year. Otherwise, these loans would become bad subsequently.

7.3 FORMS OF ADVANCES :

The loans and advances granted by banks can be broadly classified into the following categories :

- i) Loans
- ii) Cash Credit
- iii) Overdraft
- iv) Discounting of Bills of Exchange
- v) Hire purchase Advances

I) LOANS :

Under this system, the banker sanctions a specified lumpsum amount to a customer for a specified period at a certain rate of interest. A separate loan account is to opened in the name of the customer and the customer can draw the amount at any time. The interest is charged on the full amount sanctioned, irrespecting of the fact, whether it is used or not. The loan can be repaid in

instalments or in full at the expiry of the period. However, if a customer wants further loan, he can apply for fresh loans.

SHORT TERM - MEDIUM TERM AND LONG TERM LOANS :

These loans may be short term loans or medium term loans or long term loans. A short term loan is given for a period of not exceeding one year and it is given mainly for the working capital requirements of industries. Medium term loans are granted for a period not exceeding 5 years. Loans give for a period of 5 years and above come under the category of long term loans. Long term loans are granted for meeting capital expenditure like purchase of land, machinery, construction of factory building etc.,

II) CASH CREDIT :

Under this system a customer is permitted to borrow money upto a particular limit against sufficient securities. A separate account is opened for the purpose. The borrower can withdraw money from this account as and when he needs it, and at the same time, he can deposit any surplus funds into this account and borrow again. Thus, deposits and withdrawals are frequently effected in this account. There is no necessity to maintain a credit balance at any time.

Cash credit system is very popular among large scale commercial and industrial concerns in India. Though, it is generally sanctioned for a period of one year, in actual practice, it is renewed year after year. It is highly flexible, since, the cash credit limit can be increased or decreased according to the circumstances depending upon the availability of securities to cover the cash credit limits.

Interest on cash credit is charged only on the actual amount utilised. How ever, there is a minimum interest clause or a commitment change. If the sanctioned limit is not at all utilised, the minimum clause say 1/4th or 1/3rd of the limit will be applicable. It means interest will be charged on this 1/4th portion or 1/3rd portion of the cash credit limit sanctioned.

III) OVER DRAFT :

Overdraft is an arrangement, whereby a customer is allowed to overdraw his current account upto a specified limit. So, overdraft is sanctioned in the current account itself. It is purely a temporary one and it is also granted against securities. So, overdraft is not granted on a regular basis as in the case of cash credit. Withdrawals and deposits can be made frequently, interest is charged on the amount actually utilised. However, there is a minimum interest clause, which will apply in case the overdraft is not made use of. This type of advance is very popular among the business people.

IV) DISCOUNTING OF BILLS :

Under this type, the banker lends money against the bill of exchange or a promisory note. A holder of bill has to wait, till the maturity of the bill, say 3 months, to realise the amount of the bill. But, if he is in urgent need of money, he can take the bill to his banker and discount it. It means, the banker will credit the account of the customer, who brings the bill for discount, after deducting certain charges from the amount of the bill. The charges are called discount charges and they constitute an income in the banker.

It is a kind of clean advance since, the banker has no other security except the bills. Hence, this type of advance is granted only to well known and financially sound parties. Sometimes, a banker may purchase a bill instead of discounting it. The advantage of purchasing a bill is that the banker becomes a holder for value of such a bill. Since, he becomes the owner of the bill. So he can exercise his right as a pledge over the good covered by that bill, in case, it is dishounoured.

V) HIRE PURCHASING ADVANCES :

Hire purchase advances are very popular in western countries. It is gaining popularity in our country also. Under this system, banks provide finance to business concerns engaged in hire purchase business. They do not give finance to ultimate buyers directly. If they do so, it comes under the category of 'personal loans'. The business houses engaged in Hire purchase selling, obtain loan facilities on the security of hypothecation of goods sold out on hire purchase basis. Hire purchase business is very popular in the case of durable goods like TV sets, Refrigerators, Motor vehicles etc., This type of advance is popular, particularly in transport operations.

7.4 CLASSIFICATION OF LOANS AND ADVANCES :

According to the Banking Regulation Act 1949, the loans and advances granted by banks can be broadly divided into two namely

i) Secured Advances
ii) Unsecured Advances

I) SECURED ADVANCES :

Under the Banking Regulation Act 1949, "Secured loan or advance means a loan or advance made on the security of assets, the market volume of which is not, at any time, less than the amount of the loan or advance". This definition clearly pinpoints the two important features of a secured advances; They are ;

a) The loan must be granted against some tangible security and
b) The market value of the security should be always greater than the amount of the loan.

II) UN-SECURED ADVANCES :

The Banking Regualtion Act again point out that "unsecured loan or advances means a loan or advance not so secured". It means, in the case of unsecured advances, loans are granted without any tangible securities. These advances are otherwise called clean advances. Advances against the personal security of the borrowers, discounting of bills and advances against guarantees come under this category.

This type of advances are granted to customers on the basis of their personnel security viz., honesty, integrity, business reputation, promptness etc., confidence in the borrower is the basis of unsecured loans.

SECURED ADVACES :

A secured advance is one which has been granted against some tangible securities, the value of which is more than the amount of the loan granted. Secured advances are more safer than unsecured advances because, in the event of default of the borrower, the banker can sell the securities

and appropriate the sale proceed towards his loan account. Even then, a banker should be careful because, certain securities have some interest defects. The borrower might offer certain securities over which he may not passes any ownership at all. Such securities cannot be enforcable. Again, someothers are not easily markatable. A good security must possess the following qualities.

7.5 CANONS OF A GOOD BANKING SECURITY :

I) FREE FROM ENCUMBERANCES :

The borrower should have an absolute title over the property offered as security. In other words, the security must be completely free from prior charges. If the borrower's title is defective, the banker can not obtain a better title.

II) EASY MARKETABILITY :

The security offered must be such that, it is easily marketable without loss in its value. In otherwords, it must possess the quality of liquidity. If the event of default, it the securities cannot be sold in the market, there is no point in accepting such securities.

III) EASY STORABILITY :

The securities should not pose a problem of storage to banker. For example, certain goods like timbers, inflammable articles, etc., require huge and special storages which are costly. Securities like documents of tite to goods, shares, consumer goods etc., can be stored without much difficulty.

IV) DURABILITY :

The banker must see whether the security possess the quality of durability. Durable goods alone can be stored for a reasonable period of time. Perishable goods cannot be stored for long and hence, they are not accepted as good bankig securities.

V) FREE FROM PRICE FLUCTUASIONS :

An ideal security is one which is free from wide price fluctuasions. When the price of the security falls suddenly, the value of the security becomes lesser than the amount of the loan granted. Hence, there arises a necessity of demanding further securities or reducing the amount of the loan already sanctioned. It involves additional burden on the part of a banker.

VI) EASY ASCERTAINMENT OF VALUE :

The security must be capable of being valued without much difficulty. For example, daily market reports are available for certain securities like gold, silver, stock exchange securities etc., But in the case of securities like land and buildings, such reports are not available and hence their valuation becomes a difficult task.

VII) EARNING OF INCOME :

A good security must be capable of earning income. Such incomes can be appropriated towards the loan amount. For instance, stocks and shares of well established companies earn a steady dividend. Such securities are preferable to a banker.

VIII) FREE FROM DISABILITIES :

Certain securities are crippled with certain disabilities and a banker should avoid such securities. For example, a partly paid up share, a life Insurance policy where the age has not been admitted etc.

IX) FREE FROM HEAVY COST OF HANDLING :

Morever, the securities should not involve much handling cost. In the case of advances against wheat, the banker has to maintain godowns, appoint inspectors and store keepers, pay for insurance etc., Bulky materials which are difficult to store and expensive to handle shoud not be accepted.

7.6 GENERAL PRINCIPLES OF SECURED ADVANCES :

Though secured advances are safe from a banker's point of view, any negligence in creating a charge on the security or any ignorance about the nature of the security will land him in trouble. Therefore, a banker has to observe the following general principal for secured advances.

1) VALIDITY OF THE TITLE OF THE BORROWER :

First of all, the banker must as certain whether the borrower has a good title to the security. In any case, a banker cannot obtain a better title than that of the borrower. If he is satisfied with the title of the borrower, then, he must get the title transferred to him by executing the necessay documents.

2) NATURE OF THE SECURITY :

The banker must pay attention to the nature of the security. He must see whether the security prosses all the qualities of a good security. Securities must be durable and they must be storable.

3) FREE FROM DEFECTS :

In case of secured advances, a baner relies more on the security rather than, the credit worthiness of the borrower. Hence, the banker should see that these securities are completely free from defects. Certain securities have some inherent defects in them. For example, a partly paid up share, a life policy without surrender value or without admission of age etc.,

4) DOCUMENTATION :

The lending function of a banker must be adequately supported by appropriate documents. Therefore, documentation is an important set in bank lending. Documentation is nothing but the process of putting down the terms and conditions of the loan sanctioned, together with the security accepted in writing. It is an agreement between a banker and a customer, specifying their rights and liabilities that arise, in respect of the loan sanctioned. The documents which a branker normally obtains depends on the nature of the security and the type of the loan. Certain documents have to stamped as per the Stamp Act. The documentation procedure differes from bank to bank. Generally following documents are insisted upon, in the case of secured advances.

i) A letter of declaration confirming the genuine title of the borrower to the security.

ii) A letter of continuty stipulating that the security will be a continuing one and it would cover the existing and future debt also.

iii) A letter of lien giving the power to retain the security in respect of the general balance due to the banker.

iv) A letter of pledge or hypothecation, creating a charge on the securities given

v) A promissory note, promissing to pay the loan on demand

vi) A letter of undertaking, agreeing to send periodical statements of stocks and to allow for inspection of goods

vii) Mortgage deed along with the documents of title to properties.

5) MARGIN :

Another important principle is that a banker should maintain sufficient margin on the securities while advancing money. No banker advances money upto the full value of the security. He ratains some amount as margin. Thus, margin denotes the difference between the value of the security and the amount of the loan sent.

Margin = Value of the security - Amount of Loan granted

Thus, margin is nothing but a provision for safety.

7.7 MODES OF CREATING A CHARGE OF SECURITY

The way by which a banker obtains control over the security is called model of charging. If the security is not properly charged in favour of a banker, he will remain as an unsecured creditor. There are different methods of charging, a banker has to select an appropriate one depending upon the nature of the security and the type of loan. Following are the important methods of charging :

i) Lien

ii) Pledge

iii) Mortgage

iv) Hypothecation

i) Lien :

A lien is the right of a person to retain the goods in his possession until the debt due to him has been settled. For instance, a creditor who has in his possession, goods of his debtors, may have a lien over the goods in respect of the money due by the debtor. This right to retain goods as security is known as lien.

A Banker's lien is always a general lien. He has a right to retain the security in respect of the general balance due to him. In exceptional cases, he acquires the right to sell the securities, after giving a reasonable period of notice to the borrower. Thus, lien acts as an implied pledge.

KINDS OF LIEN :

Lien is of two kinds - particular lien and general lien. A particular lien is one which confers a right to retain goods in connection with a particular debt only. In other words, a particular lien applies to one transaction or certain transactions only. For example, a watch maker has a lien over the watch till the repair charges due from the owner of the watch are paid to him. General lien on the otherhand, gives a right to a person to retain the goods not only in respect of a particular debt but also

in respect of the general balance due to him. It extends to all transactions and thus, it is more extensive than that of a particular lien.

Generally, a banker has a right to exercise both kinds of lien. His general lien confers upon him the right to retain the securities in respect of the general balance due from the customer. In Brando Vs Barnett case, it was need "Bankers most undoubtfully have a generally lien on all securities deposited with them as bankers by a customer unless there is an express contract or circumstances that show an implied contract in consistent with lien".

7.7.1 Pledge :

The Indian Contract Act section 172 defines pledge as "the failment of goods of security for payment of a debt or performance of a promise". The person who pledges the property is called the pledger or bailor or power. The person to whom the property is bailed is called the pledge or bailee or pawnee. Section 172 lays down the following conditions :

- there must be bailment of goods
- the intention of bailment is to provide security for the payment of debt.
- when the debt is repaid, goods must be returned.

This method of charging is suitable to movable properties such as goods, documents of title to goods, stock exchange securities etc.,

ESSENTIAL FEATURES OF PLEDGE :

To constitute a valid pledge, the following conditions must have been fulfilled.

i) Delivery of goods :

Without the delivery of goods, there can not be any pledge at all. It means that, the securities should have been delivered to the banker at the time of getting an advance. The delivery may be actual or physical one in which case, there is a physical transfer of goods from the pledger to the pledgee. Delivery can be done by handing over the key of the godown where goods are kept as securities or by divering the documents of title to goods which have been drawn against goods.

ii) Transfer of possession :

Under pledge, the pledger transfers only the possesion of goods, subject to a charge and not his ownership to the goods. The pledger always remains the owner of the security. The possession vests with the pledgee till the loan is repaid. Pledge is lost when possession is lost.

iii) Existing Goods only :

A pledge can be created only in respect of existing goods, which are in the possession of the pledgee. These cannot be any failment of future goods.

iv) Right of sale :

The most important feature of pledge is that the pledgee has a right to sell the security, in case, the pledger fails to repay the loan with in the specified period. The pledgee can exercise this right only after giving a reasonable period of notice.

v) Agreement :

An agreement in writing between the pledger and pledgee for creating a charge is essential, though not necessary. An argument of pledge in writing is always advisable.

vi) Right of Lien :

So long as the loan together with the accured interest thereon is not paid, the pledge has a right to retain the possesion of goods pledged. No other creditor of the pledger has any right to take away the goods from the pledge, before the loan due to him is paid. Generally, in actual practices, the contract provides for a general lien the interest of the banker.

vii) Redelivery of Goods :

Once the loan is repaid, the goods under pledge must be redeliverd to the borrower. In Dhanalakshmi Vs K.K.Jose (1993), it was held that if the pledge bank is not in a position to redeliver the pledged goods, he is not entitled to sue on the debt and realise the amount due.

ADVANTAGES OF PLEDGE :

a) Simple formality :

The formalities connected with the creation of a pledge are simpler than that of a mortgage.

b) Easy to Sell :

Since the pledged goods are in the custody of the banker as a pledge, he can easily sell them in the market, in case of any default.

c) No Double Financing :

It will not be possible for the pledger to pledge the same goods and get another loan from another bank. The banker excercises much care and diligence over the goods through periodical inspection. Thus, double financing is avoided.

d) No Manipulation of Stock :

Manipulation of stock becomes a difficult affair since, the pledged goods are under the full possession and control of the banker or they are subject to strict supervision.

e) Protection from Loss :

In case of any loss or damage of to the pledged property, the banker can recover the amount from the insurance company. It is so because, at the time of creation of pledge itself, the banker insists upon the compulsory insurance of all pledged goods, against all losses.

PRECAUTIONS :

Though pledge is the most satisfactory method of creating charge, a banker has to take the following precautions :

- Ensure ownership
- Take reasonable case
- Exercise full control
- No unauthorised use
- Put up sign boards
- Draft the agreement carefully.

7.7.2 Mortgage :

A Mortgage is a method of charging which can be created only in respect of immovable properties like land and building.

The Transfer of Property Act Section 58 defines Mortgage "as the transfer of an interest in specific immovable property for the purpose of the securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to Recuriary Liability". The person who transfers the interest in property is called a mortgager and the person to whom it is transferred is called a mortgage. The document by which this transfer is effected is called the mortgage deed.

FEATURES OF A MORTGAGE :

i) Immovable Property :

A mortgage can be effected only in respect of immovable properties. Immovable properties include land and buildings, trees in the forest, machinery in factories etc.,

ii) Transfer of Interest :

Creation of a mortgage requires the transfer of interest in a specific immovable property. It does not mean transfer of ownership. In fact, the mortgager transfers some of his rights on the property to the mortgage. The mortgaged property cannot be sold without the consent of the mortgager in the even of any default.

iii) Specific Property :

The interest to be transferred is always with respect to a specific property. It must be made specific through proper identity like its size, location and boundaries etc.,

iv) Possession with Mortagage :

The actual possession of the mortgaged property is with the mortgager. He need not always transfer it to the mortgage.

v) To secure a loan :

The object of creating a mortgage is either to secure a loan or to perform on engagement. But a banker is vitally concerned with the first objective i.e., securing a loan.

vi) Reconvenance of Interest :

On repayment of the loan together with interest, the interest in specific immovable property is reconveyed to the mortgager. Thus, the mortgager gets back all his interest and rights in the property. Mortgaged as soon as he repays the loan.

vii) Rights of Sale :

In the event of non repayment of the loan, the mortgagee has a right to sell the mortagaged property through the intervention of the court. The mortgagee has a right to sue for the mortgage money in all cases.

viii) Mortgage Deed :

An agreement in writing between the mortgager and the mortgage is essential for creating a mortgage. The deed should contain all safety clauses to protect the interest of the banker in all situations.

KINDS OF MORTGAGES :

Following are the types of mortgages

1) Simple mortgage
2) Mortgage by conditional sale
3) Usufructuary Mortgage
4) English Mortgage
5) Mortgage by Deposit of title deeds
6) Anomolous Mortgage

1) Simple Mortgage :

Under this, the mortgager does not transfer the possession of the property, but promises to pay the mortgage money. In the event of his failure, he permits his property to be sold through the intervention of the court.

2) Mortgage by Conditional Sale :

Under this, the mortgager obstensibely sells the property to the mortgage on condition that the sale would become void on payment of the mortgage money, when the loan is repaid, the mortgagee retransfers the property to the mortgager.

3) Usufructuring Mortgage :

Under this, the mortgage is authorised to retain the possession of the property till the loan is repaid. He is also authorised to receive the income like rents and profits arising from that property. It is aporpriated towards the loan amount. In the event of non-payment, the mortgage can sue neither for the mortgage money nor for the sale of the property. The only remedy is to retain the possession of the property and receive the incomes on that till the loan is settled.

4) English Mortgage :

Under this, the mortgager transfers the property absolutely in favour of the mortgagee subject to the condition that retransfer is effected on repayment of the mortgage money.

5) Mortage by Deposit of Title Deeds :

This type of mortgage is called equitable mortgage. Under this type :

- There is a more deposit of title deeds of property.
- The intention of the deposit is to secure a loan

6) Anomalous Mortage :

If any mortgage does not come under any one of the above five mortgages, it is a case of Anomalous Mortgage. In real practice, it usually takes places in the form of a combination of any two mortgages mentioned above.

EQUITABLE Vs LEGAL MORTGAGE :

The trasfer interest in a specific immovable property is the main subject matter of mortgage from the point of view of transfer of title to the mortgaged property, mortgages can be classified into two namely 1) Equitable Mortgage 2) Legal mortgage

EQUITABLE MORTGAGE :

An equitable mortgage is created by a more deposit of title deeds to properties.

Features :

a) Mere Deposit of Title Deeds :

An equitable mortgage is created by a more deposit of the title of deeds to properties.

b) Intension to secure a Loan :

The intension of the deposit of title deeds must be only to secure a loan and not for anything else. In United Bank of India Vs Lekharam, Case it was held that to constitute an equitable mortgage, there must be a deposit of title deeds with an intension to secure a loan.

c) No Registration of Documents :

An equitable mortgage does not require the documents of title deeds to be registered for the purpose of obtaining a loan.

d) Existence of a Debt :

The creation of an equitable mortgage requires the existence of a debt. The debt may be an existing on or a future one.

e) Retransfer of Documents :

Another feature of this mortgage is that when the mortgage money is repaid, the documents have to be retransfered to the mortgage.

f) No Right to sell without the Intervention of the court :

In case the borrower makes as default, the mortgages cannot sell the property without the intervention of the court. He has to file a suit and obtain a degree, either for the recovery of the loan or for the sole of the property.

ADVANTAGES :

- Less formalities
- Less expensive
- Borrower's reputation not to be affected

DISADVANTAGES :

- There are chances for the existance of prior equitable mortgages in respect of the same property.
- There is a risk of subsequent legal mortgage in favour of another party in respect of the same property.
- In the event of non payment of the mortgage money, the banker cannot sell the property without the intervention of the court. Pursuing in the court is a time consuming process.

An equitable mortgage can be created by any one of the following ways :

i) By more deposit of title deeds

ii) By deposit of title deeds along with a memorandum

iii) By deposit of title deeds along with a power of attorney.

LEGAL MORTGAGE :

A legal mortgage is one where, the mortgager transfers absolutely his legal title in the mortgaged property to the mortgage, by executing a deed. This deed has to be registered. Its execusion requires payment of stamp duties, registration fee etc., So it is a cumbersome and costly affiar. Again, it affects the reputation of the borrowers because registration of the documents serves as a public notice.

Can repayment of the loan, the legal title has to be retransfered to the mortgager. It again involves payment of registration charges, stamp duties etc., Hence, creation of a legal mortgage is always very expensive. But from the banker's point of view, legal mortgage is preferable because, in the event of non repayment of money, he can sell the mortgaged property without going to the court.

7.7.3 HYPOTHECATION :

Hypothecation is also called "Mortgage of Movable Property". Manufacturing concern cannot pledge their raw materials which are required for daily production. In such cases, hypothecation is the only answer. It is an extended idea of pledge only. According to Dr. Hart, Hypothiecation is nothing but a charge against property for an amount of debt, where neither ownership nor possession is passed to the creditor".

Thus, manufacturing concerns can continue their production without any interruption by hypothecating their raw materials. Under this method, the banker is having the least control over the security and hence, it is a very risky advance. It is also called open loan facility and it is so because, the loan is granted only against an obligation to repay the money and not against any tangible security in the true sense of the term.

FEATURES :

i) No Transfer of Possession :

Under hypothecation the physical possession of goods always remains with the borrower. Actually, the banker gets only the constructive possesion. The borrower agrees to give possession of the goods when called upon to do so by the banker.

ii) No Transfer of Ownership :

There is also no transfer of ownership of goods to the banker. The ownership always remains with the borrower.

iii) Obligation to Repay a Debt :

Under this, there is an obligation the part of the borrower to repay a debt. In the event of non-payment, he agree to give the physical possession of the goods to the banker. It is this obligation which constitutes the real security for the loan.

iv) Right of sale through Court :

In the event of non-payment of money, the banker has to file a suit and obtain a decree either to recover the money or to sell the security. However, if the agreement provides for the sale of the security in the event of non payment of the debt, the banker can do so without the intervention of the court.

DRAWBACKS :

a) Least control over the security :

The banker is having the least control over the security. Both ownership and possession of the hypothecated goods remain with the borrower. So, he can easily indulge in fradulent activities.

b) False Stock Statements :

The borrower may give false and inflated stock statements against which, he may enjoy over credit facilities.

c) Double Financing :

The borrower may hypothecate the same stocks of goods with different banks and get different loans.

Precaution to be taken :

- obtain a letter of Hypothecation.
- obtain an undertaking saying that the borrower has not taken from any bank against the same goods.
- get correct statements of stock frequently
- pay frequent visits to the godown of the stock
- if necessary, obtain personal guarantee of the officer / director of the company
- Insist on the borrower to insure the stocks
- display a Board printing out “goods hypothecated to bank” to avoid any counter claim by anybody else.

7.8 ADVANCES AGAINST COLLATERAL SECURITIES :

Generally, banks advance money against certain securities. There securities may be broadly classified into two - personal and tangible. Advances against personal securities are in the form of unsecured advances, where the customer executes a promissory note or accepts a bill of exchange. To safeguard his interest, the banker insists upon some guarantees of respectable third party and this guarantee constitutes a personal security.

Tangible securities refer to those securities which can be seen and which can be realised in time of need. If may also be called collateral securities. They refer to all those securities deposited by a customer to secure a loan. Following are various types of collacteral securities against which the banks will provide advances.

7.8.1 ADVANCES AGAINST GOODS :

Now a days, most of the loans are secured against goods. Goods is a broader term which inclues food products, raw materials, agricultural products and manufactured products including minerals. Advances against goods are mainly granted for working capital requirements of business and industries. Goods as securities are popular among bankers due to the following reasons.

ADVANTAGES :

- Goods are Tangible security and can be sold in the market when there is default.
- Easy realisability by disposing off in the market
- Easy ascertainment of prices of goods
- No price fluctuations
- Short period Advances - most of the goods cannot be stored for a long period.
- Easy to create charge
- No need for registration and stampduty

DRAWBACKS :

However, these sounds are not without risks. Following are some of the drawbacks attached to goods.

- Risk of storage and verification
- There is risk of fraud in quality and quantity of goods
- Risk of Deterioration in quality over a period of time : eg : sugar & Jaggery
- Risk of price fluctuations of agricultural and industrial goods in different seasons.
- Heavy transport cost involved to bring to the market for sale
- Risk of prior charge of the same goods.

PRECAUTIONS :

The Banker should be very cautious while granting advances against goods. He should take following precautions.

- The bankers should take into account the honesty, inegrity and Trust worthiness of the borrower
- The banker should find out whether the borrower has sufficient experience in business / trade
- Loan to be granted only for productive purposes and not for speculative and hoarding activities
- Banker to ascertain whether borrower was a genuine title to the goods
- Pay special attention to the nature of goods
- Care should be taken to value the goods and thereby sufficient margin could be fixed.
- Ascertain the prices of goods in different markets.
- Bank's Name Board should be affixed outside the godown
- Godown keys should be kept in an strong room under dual control i.e., the banker and borrower.
- Goods are to insured against all possible risks.
- Banker conducts periodical inspections to see the quality and quantity of goods.
- Strict supervision over the release of goods when the loan is paid implementations by the borrower.
- Banker to take delivery of goods before granting the loan.

- Banker to deal with the owner of the goods while creating the charge.
- R.B.I.'s directives with regard to margins and other stipulations should be carefully followed by the banks.

7.8.2 DOCUMENTS OF TITLE TO GOODS :

The documents of title to goods are those documents which are drawn against goods. Hence, these documents actually represent goods. The delivery of these documents actually amounts to a symbolic delivery of goods represented by them. Banks find it more easy to deal with these documents than physically dealing with the goods. Therefore, these documents are very popular among banks. Following are the documents of title to goods.

1) Bill of leading
ii) Railway Receipt / Lorry Receipt
iii) Dock Warrant
iv) Warehouse keeper's certificate
v) Delivery order

FEATURES OF DOCUMENTS OF TITLE TO GOODS :

1) Most of the documents are issued by the transport authorities acknowledging the receipt of goods on board and undertaking to deliver the goods to the person named in the document
2) The documents, except warehouse keeper's certificate, carry with them a right of ownership to goods.
3) They can be transferred by endorsement and delivery. Since they possess one of the qualities of a negotiable instrument, some authorities call them as "Quasi Negotiable Instruments".
4) A warehouse keeper's certificate is issued by a warehouse keeper simply acknowledging the receipt of goods in the warehouse. He does not undertake to deliver the goods to any person named in the document. He simply awaits for the instructions of the owner of the goods. So it does not carry with it a right of ownership to goods.
5) If the owner wants to take delivery of goods from the godown, he issues an order to the warehouse keeper. That order is called delivery order.

ADVANTAGES :

Since these documents are drawn against goods, they simply represent goods. Hence, all advantages of goods are automatically applicable for the documents. Following are the additional advantages.

- It serves as a reliable security.
- Can be transfered by more endorsement and delivery
- Formalities are less.

DRAW BACKS :

- There is greater risk of fraud of regards the contents of packages.

- There is greater risk of dishonesty of borrowers
- Possibility for forgery of endorsement of documents
- Documents are partly negotiable - Banker can not obtain a better title that of his customer
- Some unscrupulous person can take the delivery of goods without surrendering the document by more executing an indemnity bond.
- There is a tendency among borrowers to deposit bogus Railway receipts / Lorry Receipt with a view to defraud the banker.

PRECAUTIONS :

In order to avoid the above risks, the banker should take following precautions.

- Banker to see the borrower to be honest, reliable and trust worthy.
- Banker to ascertain the genuiness of the documents
- Banker should see the endorsement on the document is genuine.
- Banker should insist upon the borrower to endorse the document in blank. On such a case, any charges payable on the document like freight etc., will have to be paid by the borrower himself.
- Documents should not contain clauses like “Containess leaking” or “defective packages” etc.,
- Banker should insist on the packers certificate from the packers to have confirmation of each and every package.
- Banker to ensure that the goods are adequately insured to the full market against all risks.
- Banker should inform the issuing authority concerned about the creation of charge on the document to prevent the borrower to take delivery of goods.
- Obtain a memorandum of charge signed by the borrower to get power to sell the goods.
- Banker to be careful in releasing the documents before repayment of loan and he has to take a “Trust Deed” from the borrower.
- Banker has to take additional precautions in the case of bill of lading, Railway / Lorry Receipts warehouse keeper’s certificate, Dock warrant and Deliver order etc., whie advancing the loans against the documents of title to goods.

7.8.3 LIFE INSURANCE POLICIES :

A Life insurance contract is a contract between an insurance company and a person called assured, whereby, the insurance company agrees to pay a certain sum on the happening of a certain event viz, death (in the case of whole life policy) or after the expiry of a fixed period or death whichever is earlier (in the case of endowment policy), the consideration for this contact is that the assured agrees to pay a certain sum either in one lumpsum called annuity or in instalments called premium.

A Life Policy gives protection to the family members in the case of ultimely death and at the same time, it acts as a sort of investment if death does not occur. Loans can be obtained from the LIC in times of need against the security of the policy. Bankers also consider this as a good security

due to the following reasons.

ADVANTAGES :

- Life Insurance policy is a tangible security. So long as the premiums are paid regularly, banker need not worry.
- LIC policy is highly liquid and surrender value can be obtained at any time.
- The value of Life Policy can be easily ascertained by the banker with an enquiry.
- The value of policy increases year after year and surrender value goes on increasing
- The security can be easily realised when the borrower make any default. In the case of death also, the loan amount can be easilyadjusted with the maturity value of the policy.
- The policy can be assigned in favour of the banker very easily by means of giving a notice of assignment to the company.
- The value of his security is not subject to price fluctuations as in the case of stock exchange securities
- It is easy to ascertain the title of the borrower.
- Banker can safely rely upon the policies issued by the LIC

DRAW BACKS :

Though there are many advantages, there are certain draw backs associated with life policies. They are :

- When the regular premiums are not paid, the policy will lapse.
- A banker cannot find out whether the policy holder has disclosed all materials fact or not. However, it is maintained in at most good faith.
- Where there is no insurable interest in life insurance at the time of taking and a policy, the contract would become void.
- There is chance for taking a duplicate policy by the policy holder and another loan can be taken from another bank.

PRECAUTIONS :

If the following precautions are taken into account, Life Policies can be very well accepted by bankers.

1) The banker should see whether the policy is in force or not. The policy should not have been lapsed. He must ensure that the premiums have been paid up to date.
2) Before granting the loan, the banker should is certain the surrender value from the insurance company. The banker should maintain 10% to 15% margin on the surrender value of a provision of for safety.
3) The banker should ensure that the borrower has an insurable interest. There is no problem if the policy is taken on his own life. But if its is taken on the life of a third party, the banker must be very careful.
4) The banker should verify whether the age of the person is admitted by the insurance company or not. He should not accept policies where the age has not been admitted.

5) The banker is advised to prefer endowment policy than the whole life policy as the former matures with in a stipulated period and the banker is certain about the source of repayment.

6) The banker has to ascertain from the company that there are no encumberances on the policy of the borrower.

7) The banker prefers legal charge rather than equitable charge of the LIC policy. Loans can also be obtained by simple depositing the policy with the banker. It is a case of equitable charge. In such a case the banker must get a man date along with the deposit of the policy.

7.8.4 STOCK EXCHANGE SECURITIES :

Stock Exchange securities refer to those securities which are regularly brought and sold in a stock exchange market. The securities traded on the floor of a stock exchange are :

1) Securities issued by the central government and state governments like loan bonds, treasury bills etc.,

ii) Securities like debentures and bonds issued by the semi government organisations like Port trust, Electricity boards.

iii) Shars and Debentures issued by the Joint Stock Companies.

Stock exchange securities have become very popular due to the development of the capital market in India. They are considered as good securities due to the following advantages.

ADVANTAGES :

i) Title of the borrower can be easily ascertained.

ii) Market value of the security can be easily ascertained

iii) Shares of good companies and government securities are in great demand and they are quite reliable.

iv) Shares can be disposed off in the market very quickly and liquid cash could be obtained.

v) The prices of good companies shares do not fluctuate much and they are considered as safe securities.

vi) Securities like bearer securities, share warrants and government promissory notes are fully negotiable and they can be easily transferred by more delivery.

vii) These securities earn income in the form of interest and dividend and this income can be appropriated towards loan amount.

viii) The formalities connected with the creation of a charge on these securities are very simple. It is only through more delivery and does not involve much expenses.

DRAW BACKS :

Despite the above advantages these are certain risks in advancing money against stock exchange securities. The drawbacks are as follows :

- A share may be partly paid up, the fact of the which is not indicated on the fact of it. A partly paid up share is considered to be risky security bacause if the borrower fails to pay the calls,

the shares will be for feited and there is no market for such shares as they would not be quoted in the market.

- When the shares of a company ar not quoted in the market, it is very difficult to find out their market value.
- In the case of private companies shares, there is a restriction on the transfer of their shares. Hence, a banker cannot realise such securities.
- All companies do not declare a steady dividend and it fluctuates depending on the profit of the company.
- There is a possibility of producing a bogus share certificate and obtain a loan.
- It is also possible to obtain a duplicate share certificate on the ground that the original one has been lost. Loans can be raised against bogus certificates.

PRECAUTIONS :

The above risks can be reduced, if the following precautions are taken :

i) The banker must study the nature of the business of issuing company, the past history and future prospects. He has to ascertain the company's earning capacity and this will have a decisive influence on the value of the security.

ii) The banker must see whether the management of the company is efficient, competent and capable. In case the management is inefficient, the banker would not prefer the securities issued by such a company.

iii) A Banker should always prefer debentures and preference shares to equity shares as the former are safe than the latter. Price fluctuations do not effect the debentures and preference shares.

iv) The banker should maintain sufficient margin on the value of the securities. He should not accept partly paid shares because they are subject to many risks;

v) If the shares are quoted in the market, the banker can not findout their value and he never accepts such securities.

vi) The banker should never accept private companies shares, in the event of default of the borrower, he cannot sell them to anybody. Further, there is a restriction on the transfer of such shares.

vii) It is not advisable to accept shares, standing in the name of third party, as securities for a customer's loan. The banker can permit after getting the letter of remunciation from the third party standing that he was no objection to give them as securities.

viii) A bank cannot accept its own shares as a security. It is so because, in the event of liquidation of banks, such securities become valueless.

ix) The RBI is issuing directives from time to time regulating the advances against shares. Such directive must be duly complied with.

A Banker cannot advance money blindly against every share offered as security. All the shares do not command the same respect in the market. The banker also prepares a list of securities

which could be readily accepted as securities. The list is called " approved list of securities". While preparing the list, the banker takes into account the goodwill of the company, nature of management, marketability of its shares, its dividend paying capacity etc., If the security does not come under the approved list, it will not be accepted by the banker for an advance.

7.8.5 SUPPLY BILLS :

The government and semi-government bodies are the biggest buyers of goods. They invite tenders from the public for the supply of goods. A party whose tender is accepted get an order for the supply of goods. Similarly, the government contract work is given to contractors by inviting tenders. The supplier despatches the goods to the departments concerned by rail or road after getting an inspection note certified by a government officer. Thereafter, the supplier prepares a bill for the goods supplied. Such bill is known as supply bill.

The railway receipt or bill of lading for the relative goods is sent direct by the supplier to the relative department and the bill for the amount is sent for collection through a bank. It is on the basis of this bill the supplier seeks an advance from the bank. Supply bill are not bills of exchange. They represent a debt arising out of a bonafide supply of goods.

RISKS IN ADVANCES AGAINST SUPPLY BILLS :

i) Clean Advance :

Advances against supply bills are virtually clean advances. The supply bill are not accompanied documents of title to goods. The security available to a banker is by way of assignement of debts represented by supply bills. So, it suffers from all draw backs of assignment of both debts.

ii) Delayed Payment :

The payment for the bills may be delayed on a account of procedural matters.

iii) Possibility of part payment :

Sometimes, the government may not pass the bill for its full value, if there is a default onthe part of the supplier in observing the terms of contract.

iv) Counter Claim :

There is always the possibility of counter claim or set off against the debt.

PRECAUTIONS TO BE TAKEN :

To overcome the above drawbacks, the banker should observe the following precautions :

i) Only to reliable customers :

The banker should grant loan against supply bills only to those customers who are honest, reliable, having sufficient experience in the businesss and are also familiar with the working of the government departments.

ii) Terms and Conditions :

The original contract entered into between the government and the supplier should be scrutinised to know the terms and conditions for the supply of goods. The banker should also ensure that the terms and conditions are complied with by the borrower.

iii) Power of Attorney :

The banker should get an irrevocable power of attorney executed by the borrowers in his favour authorising him to collect the bills in respect of supplies referred thereto. The power of attorney should be registered with the government department concerned.

iv) Undertaking to pay :

The borrower should be required to give an undertaking to pay the bank the amount of bill, if any, received by him directly.

v) Adequate Margin :

The banker should keep adequate margin while advancing against supply bills. Usually, 10% to 25% margin is maintained.

vi) Departments :

The bills should be forwarded to the respective departments for payment together with a covering letter starting that the bank has made an advance to the supplier against the bill and the proceeds of the bill should be remitted to the bank direct.

vii) Follow-up :

The banker should keep a watch on payment of supply bills. If the bills remain unpaid for simetime, say two or three months, the advance should be cancelled and the banker should recover the amount from the borrower.

7.9 CASH CREDIT SYSTEM - CHORE PANEL'S RECOMMENDATIONS

CASH CREDIT SYSTEM :

All the commercial banks in India meet the working capital requirements of the industry through overdrafts, cash credits and discounting of commercial bills of exchange. Cash receipt has become a popular form of lending, accounting to more than half of the total credit. Under the cash credit facility a borrower is allowed to withdraw funds from the bank upto the sanctioned credit limit. He is not required to borrow the entire sanctioned credit at once, rather he can draw periodically to the extent of this requirements and repay by depositing surplus funds in his cash credit account. There is no commitment charge. Therefore, interest is payable on the amount actually utilised by the borrower. Cash credit limits are sanctioned against the security of current assets. Cash credit is most flexible arrangement from the borrower's point of view. It provides for the fixation of credit ceiling to individual borrowers on the basis of maximum requirement of credit. This leads to a sizeable unutilised credit leading to a substantial gap between the sanctioned limits of cash credit and the extent of their utilisation.

The Reserve Bank of India appointed a committee in March 1979 under the chairmanship of Sri K.B. Chore to review the system of cash credit and given recommendations to minimise the problem of cash credit system in banks and suggest modifications in the existing system for greater credit discipline. The committee's task was to look into operations of the cash credit system and to find out alternative ways of controlling the flow of bank credit to industry, particularly medium and

large scale industry.

The committee submitted its recommendations in the year 1980. It had prescribed new discipline and norms for cash credits after modifying the Tandon committee norms. The RBI accepted the recommendations of the chore committee with certain modifications.

SALIENT FEATURES OF THE RECOMMENDATIONS :

The chore committee examined the various forms lending overdraft, cash credit, discounting bills of exchange and loans and advances. It was clearly pointed out that it would be difficult to replace the cash credit system totally by any other system. Therefore, the periodical review of credit limits and streamlining the system were recommended. An annual review of all borrower's accounts exceeding Rs. 10 Lakhs as working capital was suggested.

OTHER IMPORTANT RECOMMENDATIONS :

The advantage of the existing system of extending credit by a combination of three types of lending namely cash credit, loan and overdraft should be retained. At the same time, it is necessay to give some directional changes to ensure that wherever possible the case of cash credit would be supplemented by loans and bills.

- In order to ensure that borrowers do enhance their contribution to working capital and to improve their current ratio, it is necessary to place them under the second method of lending recommended by the Tandon committee which would give a minimum current ratio of 1.33:1.
- While assessing the credit repayments, the banks should appraise and fix separate limits for the normal non peak level as also for the peak level credit requirements indicating also the periods during which the separate limits would be utilised by the borrower. This procedure would be extended to all borrowers having working capital limits of Rs. 10 lakhs and above.
- The borrower should be asked to give his quarterly requirements of funds before the commencement of the quarter on the basis of his budget, the actual requirements being within sanctioned limit for the particular peak level / non peak level periods.
- Requests for relaxation of inventory norms and for adhoc increases in limits should be subjected by back to close scrutiny and agreed to only in exceptional circumstances.
- The banks should advise their own check lists in the light of the instruction issued by the RBI for the scrutiny of data at the operational level.
- Banks should review the system of financing book debts through cash receipt and insist on the conversion of such cash credit limits into bill limits.
- To encourage the bill system of financing and to facilitate call money operations, an autonomous financial institutions on the lines of the discount houses in the united states may be set up.
- The communication channels, systems and procedures within the banking system should be toned up so as to ensure that minimum time is taken for collection of instruments.
- The need for reducing the over dependence of the medium and large borrowers both in theprivate and public sectors - on bank finance for their production or trading purposes is recognised. The net surplus cash generation of an established industrial unit should be utiilsed partly atleast for reducing borrwoing for working capital purposes.

- The borrower would be required to submit his budgeted requirements in triplicate and a copy each would be sent immediately by the branch to the controlling office and head office for record. The penalty would be applicable only in respect of parties enjoying credit limits of Rs. 10 Lakhs and above, subject to certain exemptions.
- No conclusive data are available to establish the degree of correction between production and quantum of credit at the industry level. As this issue is obviously of great concern to the monetary authorities, the RBI may undertake a detailed scientific study in this regard.
- Credit control measures to be effective, will have to be immediately communicated to the operational level and followed up. There should be a "Cell" attached to the chairman's office at the central office of each bank to attend such matters. The central offices of banks should take second look at the credit budget as soon as changes in credit policy are announced by the RBI and revise their plan of action in the light of the new policy and communicate the corrective measures to the operational levels as quickly as possible.
- Banks should continuously monitor the credit portfolio of the key branches so as to be able to manage the credit portfolio more meaningfully then by attempting to oversee all the branches at a time.

7.10 KEY WORDS :

Advance : When a bank lends money on clean or on secured basis for interest to a borrower.

Assignment : Transfer of right of property to another person.

Bill of Lading : A document of title to goods signed by the carrier, acknowledging shipment of the gooods and containing the terms and conditions of carriage.

Cash Credit : A running account overdrawing facility which is usually against the goods

Dock Warrant : A document issued by a Dock Company stating that the goods as described therein have been received and are held at the disposal by the person mentioned there in.

Hypothecation : A system of taking the security where by both the ownership and possession are allowed to be with the borrower.

Lien : Right to retain possession of goods until the amount due is paid.

Mortgage : A transfer of interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, for the performance of an enagement which may give rise to percuniary liabilities.

Pledge : It is the bailment of goods as security for payment of a debt or performance of a promise.

7.11 SELF - ASSESSMENT QUESTIONS :

1) What are the general principles of sound lending ?
2) Explain various forms of bank advances and examine the canons of a good banking security?
3) What are the various modes of creating a charge of security and explain the essential features of a pledge ?
4) What are various kinds of Mortgage and distingish between equitable mortgage and legal mortgage ?
5) Discuss the concept of Hypothecation and write the features and preautions to be taken while advancing a loan against hypothecation.
6) What are various types of collateral securities and explain the precautions to be taken while advancing a loan against documents of title to goods ?
7) What the advantages for a banker in the case of LIC policies for a loan and outline the precautions to be taken ?
8) What is cash credit system and examine the chore panel's recommendations on cash credit system ?

Lesson - 8

PRIORITY SECTOR LENDING - POLICIES AND PRACTICES

OBJECTIVES :

This unit is aimed at enabling the student to :

- Understand the concept of priority sector lending and its significance
- Know the priority sector lending policies and performance of Commercial Banks
- To identify the areas of priority sector lending and the schemes pertain to them

STRUCTURE :

8.1 Introduction and significance of priority sector lending
8.2 Areas of priority sector lending
8.3 Policy changes and developments
8.4 Schemes relating to Agriculture
8.5 Small Scale Industry
8.6 Traders and Small Business Entrepreneurs
8.7 Self-employees and Professionals
8.8 Transport operators
8.9 Education and others
8.10 Performance of Commercial Banks in priority sector lending
8.11 Problems of priority sector lending
8.12 Conclusion
8.13 Self - Assessment Test
8.14 Further Readings

8.1 INTRODUCTION AND SIGNIFICANCE OF PRIORITY SECTOR LENDING :

At the dawn of the Planning era in India, banking was essentially an urban oriented service. The rural economy was almost devoid of institutional credit facilities. For the modernisation of agriculture and for augmenting the food grains production, huge investment on aggriculture was essential. It was therefore, rightly thought that the banking system should also play its role in providing the necessary credit support to this crucial sector a small variation in whose output would throw the entire planning efforts out of gear. It is to be noted that the agricultural credit was accounting for less than 1 percent of the total bank credit in the late 60s. Identifying certain segments of the economy, targets were fixed for lending to them on a priority basis.

The first occasion when the term 'priority sector' was used, appears to be on Dec. 14, 1967, when Mr. Morarji Desai, the then DY. Prime Minister & Finance Minister stated in Lok Sabha that there has been public concern that several priority sectors such as agriculture, small scale industries and exports were not receiving their due share of bank credit.

Ever since its genesis, the term has been gaining such as increasing momentum that by now it appears to have pervaded entire gamut of commercial banking in our country. With the introduction of Banking Laws (Amendment) Bill 1967 in the Lok Sabha on Dec. 23, 1967, policy of 'social control' on banks was instituted. The National Credit Council was set up to assess the

demand of bank credit for various sectors of economy and to determine priorities for the grant of loans or for investment having regard to the availability of resources and the requirements of priority sectors.

During 1967-68, as a supportive measure, RBI considered the increase in bank's advances to such priority sectors namely agriculture. SSI and export eligible for refinance from them at a concessional rate apart from considering increments in such advances as liquid assets of banks for the purpose of computation of banks liquidity ratio. To give an organised thrust to priority sector lending by commercial banks, 14 major banks of the country were nationalised in July, 1969. This was considered a leap from class banking to mass banking.

8.2 AREAS OF PRIORITY SECTOR LENDING :

Commercial banks has largely neglected agriculture, small industrial concerns and business units until 1969 on the ground that rural credit was to be undertaken by co-operative credit societies and banks. Moreover, these sectors were ignored by commercial banks as the latter were owned and controlled by big industrialists before nationalisation. Accordingly, they remained largely indifferent to the credit needs of farmers, small industries, artisans and self-employed persons.

Soon after nationalisation, the priority sector lending became an important national agenda. Phenomenal progress towards this end was made by setting up study groups and targets for lending to these sectors. Moreover, other priority sectors were also added such as retail trade, professional and self-employed persons, education, housing loans for weaker sections and consumption loans.

AREAS OF PRIORITY SECTOR FINANCING :

The areas which come under priority sector for commercial bank financing include;

1. Agriculture,
2. Small Scale Industries,
3. Transport operations,
4. Artisans, professionals and self employed people,
5. Export - Import trade,
6. Education,
7. Weaker Sections,
8. Traders and small business entrepreneur,
9. Housing etc.

Majority of the areas are dealt with in detail separately.

8.3 POLICY CHANGES AND DEVELOPMENTS :

As stated earlier the Social Control over Banks introduced in 1967 followed by nationalisation of 14 major commercial banks in July 1969 was aimed at to blend banking with national priorities for promoting economic growth and social justice. This was done by introducing changes in functioning of banks with the objectives of improving flow of credit to sectors like Agriculture. Small Scale Industries and other small borrowers and opening of branches at rural and unbanked centres for improving access to banking facilities and to cultivate banking habits.

In addition to the above, the policy makers influenced the credit flow to the priority sectors by changing sectoral allocation of bank credit under a system with a time frame for achieving the targets

and creating new schemes based on the area approach for planning and disbursement of credit under the Lead Bank Scheme and the Service Area Approach. Depending on the need, from time to time, the percentages of targets to be achieved and also the definitions of various sectors, which come under Priority Sector, have been changed.

In 1974 Government of India advised Public Sector Banks to achieve Priority Sector advances not less than 331/3 of their outstanding credit by March 1979. Subsequently, RBI issued instructions in October 1980 revising this upwardly to 40% of total advances to priority sector by March 1985. Likewise again in priority sector 40% was to be set apart to agriculture i.e., 16% of total credit should go to agriculture by March 1985 and that minimum of 50% of direct lending to agriculture to go to Small and Marginal farmers by 1983 etc.

In April 1978, Private Sector banks were advised to take up implementation of DRI (Differential Interest rate) schemes along with public sector banks. In November, 1978, RBI advised them to undertake priority sector lending also to a minimum of one-third of their total advances by March 1980 as stipulated earlier for public sector banks.

In March 1982, consequent upon the announcement of New 20 Point Economic Programme, the RBI incorporated certain modifications in the profile of 'priority sector' lending. The coverage of some of the elements namely retail trade, small business, professional and self employed persons was revised. It was also added that consumption loans and housing loans granted to the beneficiaries belonging to the weaker section shall also be treated as priority sector credit even when no other productive loan has earlier or simultaneously been given to them. This is how the concept of priority sector lending was broadened.

In 1987, for laying more emphasis on direct agricultural credit with in priority sector lending, it was advised by the Reserve Bank of India that commercial banks should give such advances to the extent of 17 percent of total bank credit by March 1989 and raise them further to 18 percent by March 1990.

In 1989, the Reserve Bank of India advised foreign banks also operating in our country to undertake priority sector lending portfolio to the extent of 10 percent of their total credit by March 1989 which was to be raised to 12 percent by March 1990 and subsequently to 15 percent by March 1992. The rigors of priority sector lending by foreign banks, however, were relaxed as it was added that they may not set up rural branches and may not lend to agriculture in a big way.

In April, 1993 with the announcement of Credit Policy, the Reserve Bank of India has advised the foreign banks that those who have not met the priority sector lending target of 15 percent would be required to deposit the shortfall, at bank rate, with Small Industrial Development Bank of India (SIDBI) for on-lending. It has been further stipulated that target for priority sector lendings by foreign banks has also been raised from 15 percent to 32 percent of total credit which is to be achieved by them by March, 1994. Peculiar feature added here to the concept of priority sector lending is that foreign banks shall be allowed to treat their export credit as priority sector lending.

NARASIMHAM COMMITTEE (1991) AND PRIORITY SECTOR LENDING :

The Narasimham Committee on the Financial System 1991 was against the continuance of the priority sector lending on the grounds :

1) The priority sector should be redefined. It has suggested that priority sector lendings should be restricted only to the core sector. All other loans should be left to the commercial judgment of banks.
2) It should be fixed at 10 percent of the aggregate bank credit.
3) It should be reviewed after a period of three years.
4) It should be completely phased out gradually.

The Government of India did not accept this recommendation. However, the commercial banks have not shown any encouraging progress recently so far as credit disbursement to the priority sector is concerned.

The idea of reservation of credit for the priority sector areas was very much alien to the reformer's instincts in the early 1990s. It may be recalled that how the world bank pressed for the abolition of priority sector allocations as such. But wiser counsels prevailed. As matters have turned out, the priority sector reservation has, indeed, helped sectors such as agriculture, small scale industries, and other priority sectors whose inherent difficulties frighten away banks. This is not to deny; however, that special difficulties of recoveries in priority sector loans need to be looked into and resolved by the Government and the RBI.

PRIORITY SECTOR LENDING - TARGETS :

Targets and sub-targets are fixed under priority sector lending for domestic and foreign banks operating in India. For domestic banks, the target for total priority sector lending is 40 percent of Net Bank Credit (NBC). The sub-targets are 18 percent of NBC for agriculture and 10 percent of NBC for advances to weaker sections. There is no sub-target for advances to SSI sector by domestic banks. For foreign banks operating in India, the target for priority sector lending is 32 percent of NBC. The sub-targets are 10 percent of NBC for small scale sector and 12 percent of the NBC for export credit. Export credit does not form part of priority sector lending for domestic banks.

8.4 SCHEMES RELATING TO AGRICULTURE :

The Social Control on banks imparted a new sense of direction to the commercial banks to proceed on the untrodden path of direct financing of agriculture. The Agricultural Finance Corporation was set up in 1968 to augment commercial banks participation in agricultural financing. The nationalisation of major banks in July 1969 proved to be a turning point in this regard and has led to greater involvement of commercial banks in the financing of agriculture under the direction and persuasion of the Reserve Bank and the Central Government.

The following are the some main schemes of lending to agriculture by commercial banks.

DIRECT FINANCE SCHEMES :

1) PURCHASE OF AGRICULTURAL INPUTS AND MACHINERY :

i) Purchases of agricultural inputs :

Fertilisers, pesticides, insecticides, fungicides and weedicides, and improved seeds, high yielding variety seeds, manures etc.

ii) Purchases of agricultural implements :

Like ploughs, harrows, hoes, land-levellers, bund-formers, hand-tools, sprayers, dusters, haypress, sugarcane crushers, thresher machines, etc.

iii) Purchase of farm machinery :

Tractors, power tillers, tractor accessories, namely, discplough, etc.

iv) Purchase of trucks, bullock-carts and other transport equipment, to assist the transport of agricultural inputs and farm products.

v) Purchase of farm animals like cows, bullocks, buffaloes and poultry birds, pigs, bees, etc.

2) Development of Irrigation potential through :

i) Construction of tube-wells, tanks, etc., and purchase of drilling units.

ii) Construction, deepening and clearing of surface wells, boring of wells, electrification of wells, purchase of oil engines and installation of electric motors and pumps.

iii) Purchase and installation of turbine pumps, construction of field channels (open as well as underground), etc.

iv) Construction of lift irrigation system.

v) Installation of sprinkler irrigation system.

3) Reclamation and Land Development Schemes :

Bunding of farm lands, levelling of land, terracting, conversion of dry paddy lands into wet irrigable paddy lands, development of farm drainage, reclamation of saline lands and prevention of salinisation, reclamation of revine lands, purchase of bulldozers, etc.

4) Construction of farm buildings and structure :

Bullock-shed, implements-shed, tractor and truck-sheds, farm stores, etc.

5) Construction and running of storage facilities :

Construction and running of warehouses, godowns, soils and cold storages.

6) Production and processing of hybrid seed of crops.

7) Payment of Irrigation charges :

Charges for hired-water charges, maintenance and upkeep of oil engines and electric motors, payment of labour charges, electricity charges, marketing charges, service charges to Custom Service Units, payment of development cess, etc.

8) Development of Dairying and Anumal Husbandry in all its aspects

9) Development of Fisheries in all its aspects :

i) From fish catching to the stage of export,

ii) Financing of equipments necessary for deep sea fishing.

iii) Rehabilitation of tanks (fresh water fishing).

iv) Fish breeding, etc.

10) Development of Poultry houses and pig houses, bee-keeping etc.

11) Miscellaneous : Developments and maintenance of stud farms, sericulture, etc.

INDIRECT FINANCE SCHEMES :

1) Credit for financing the distribution of fertilisers, pesticides and seeds.
2) Loans to the Electricity Boards for reimbursing the expenditure already incurred by them for providing low tension connections from step-down point to individual farmers for energising their wells.
3) Loans to farmers through Primary Agricultural Credit Societies and other cooperatives in certain states under schemes introduced for the purpose.
4) Finance for hire-purchase schemes for distribution of agricultural machinery and implements.
5) Loans for construction and running of storage facilities (warehouses, go-downs, soils and cold-storages) in the producing area.
6) Advances to Custom Service Units managed by individuals, institutions or organisations who maintain a fleet of tractors, bulldozers, well boring equipments, threshers, combies, etc., and undertake work from farmers in contract basis.
7) Loans to individuals, institutions or organisations who undertake spraying operations.
8) Loans to Cooperative Marketing Societies and Cooperative Banks for re-lending to Co-operative Marketing Societies, provided a certificate from the State Cooperative Bank in favour of such loans is produced.
9) Loans to Cooperative Banks of producers.
10) Financing the farmers indirectly through the co-operative bank in favour of such loans is produced.
11) Loans to Agro-Industries Corporations.
12) Loans to State-sponsored Agricultural Credit Corporation
13) Advances to the Agricultural Finance Corporation

8.5 SMALL SCALE INDUSTRY :

The promotion of small industries has been regarded as an important element of the development strategy underlying our Five-year Plans. The rationale behind such an approach is that small industries provide a substantial scope for increasing employment because they are labour-intensive and require comparatively less capital.

The primary objective of SSI Policy of India during 90s as envisaged in the policy text declared during August 1991, is to impart vitality and impetus to enable this industry to contribute its mite fully to the economy in terms of growth of output, employment and exports.

The sources of finance for small industry include both internal and external. The external sources consist of the traditional money lenders, industrial cooperatives, State Financial Corporations, Development Banks, Special Institutions like Small Industry Development Bank of India (SIDBI), commercial banks etc.,

The Nayak Committee (discussed subsequently) observed that on the whole the SSI sector gets 8.1% of their output as working capital from the banking system while the large segment in SSI is getting 18.8% and tiny units only 2.7% of their outputs as working capital.

COMMERCIAL BANKS ADVANCE TO SMALL SCALE INDUSTRY :

Financing small-scale industries by commercial banks dates back to 1956, when pilot scheme was introduced by the State Bank of India, soon after its nationalisation in 1955. The activity, however, picked only in the sixties after introduction of the credit guarantee scheme by the Reserve Bank of India.

The facilities offered by banks to small-scale industries are summarised as under :

a) Meeting the working the capital requirements by :

1) granting cash credits / loan facilities against pledge / hypothecation of raw materials and financed products and hypothecation of book debts ;

2) granting bill discount / bills purchased facilities in respect of bills arising out of bonafide, commercial or trade transactions ;

b) Meeting in special cases, block capital requirements for acquisition of fixed assets against security

c) Financing within responsible limits, the requirements of technically qualified and experienced persons with good schemes for starting new industries. The persons concerned may have little or no capital of their own.

d) Financing export trade of small units by granting :

i) Foreign bills purchased facilities in respect of bills existing out of export trade :

ii) Cash Credit (packing credit) facilities against hypothecation / pledge of articles earmarked for export covered under firm orders or irrevocable LICs opened in favour of the unit.

Schemes of SSI Finance :

1) Finance Through District Industries Centres :

District Industries Centre scheme is a centrally sponsored scheme but would be implemented by the State Governments Nationalised banks have been directed to set up separate wings for development and promotion of this sector and to earmark a specified portion of their total advances for small sector.

2) Financing of Sick Units for Rehabilitation :

Commercial banks have called upon to rehabilitate and reconstruct the sick industrial units.

3) Financial Assistance to Entrepreneurs :

Some of the leading public sector banks have innovated a new scheme whereby the banks arranged technical / in plant training to the selected technocrats who have ideas of promoting industries but lacking finance. After the initial period of training the bank would help him to set up his own industrial unit with the bank's financial assistance.

4) Equity fund through Interest Free loans :

Equity support is being given to small-scale units under the Bank's Equity Fund Scheme, through interest-free loans repayable on a long-term basis.

5) Credit guarantee scheme :

With a view to safeguard the interest of lending banks and protect them from the risk arising out of lending to small scale industrial sector on the one hand and include them to take up large scale financing to these sectors.

The schemes covers all types of credit facilities granted to small scale industrial units e.g., working capital advance, term-loans, instalment credit, letters of credit, acceptance credit, deferred payment and loan guarantees.

NAYAK COMMITTEE ON FINANCING SMALL SCALE INDUSTRY :

The Report of the Committee set up by the Reserve Bank of India in December, 1991 under the Chairmanship of Shri P.R. Nayak, the Deputy Governor of the Bank, to look into the various aspects of credit requirements of the Small Scale Industries (SSI) sector has been submitted.

On an examination of the finance profile, the committee has observed that support to the SSI sector is inadequate, in as much as SSIs, as a whole, get only 8.1 percent of their output which is marginally less than what the committee considers reasonable, the village and smaller tiny industries get only 2.7 percent of their output as working capital. The committee has suggested that small unregistered units with credit limits of not more than Rs. 1 lakh should have the first claim on the priority sector to SSI and the new priority sector credit dispensation, when adopted should fully provide for the working capital requirement of all tiny units with credit limits upto Rs. 10 lakhs. The committee has also recommended that the working capital needs of other SSIs at 20 percent of the output should be pre-empted by commercial banks through an annual budgetary exercises and, if necessary, a part of resources flowing to the medium and large industries sector at present, should be diverted to fully meet the demands of SSIs.

8.6 TRADERS AND SMALL BUSINESS ENTREPRENUERS :

a. Lending to Traders :

For ensuring rapid economic development, a speeder expansion of industrial credit is to be stimulated. But it is equally essential to ensure that trade and commerce are not denied an adequate share in bank finance.

Internal trade in India is financed by money lenders, indigenous bankers, commercial banks and other institutions. In the absence of availability of reliable statistics one cannot examine the comparative role played by these institutions. Still it would be in the fitness of things to discuss how far commercial banks help in the free movement of products from the production units to consumers through various channels.

Since the primary function of banks is one of safe-guarding for their all customers; viz. wholesalers, retailers, producers and manufacturers and various other services including those of settlement and financing of business transactions. These services may be divided into two broad categories :

a) The provision of machinery for making payments ;
b) The provision of credit for traders and others.

With respect to Trade and Commerce the Banks play their role in the following areas.

SETTLEMENT OF DEBTS :

Commercial banks help the mercantile community in discharging debts by means of cheques throughout the country with out involving any large scale transfer of currency from one place to other. This is possible through the clearing houses. A debt between two merchants can be settled either by the creditor drawing a bill on his debtor and selling it or discounting it with the bank or by the debtor sending his creditor a payment through a cheque or a bank draft.

THE PROVISION OF CREDIT :

Except in retail trade, very few transactions in modern business are carried through cash. The whole super structure of present day business is built on credit and banks act as intermediaries to channels credit into sectors having potentialities for the nation's economic development. A business requires short-term, medium term or long term development. A business requires short-term, medium-term or long-term credit at various intervals of time. Banks normally provide short-term credit to finance the purchase of stock to finance sales and to pay for capital equipment.

CASH CREDIT :

It is an arrangement by which a bank permits traders to borrow money upto a definite limit against either a bond of credit by one or more sureties or some other securities. This method is most popular in India because it is highly advantageous for the traders who need not withdraw the whole of required money at once but can draw in installments as per requirements. The lean amount is usually repayable on easy conditions.

OVERDRAFT :

Banks frequently authorise the traders to draw cheques on his current account, a specific amount more than the balance therein, usually against collateral securities. Such a system is quite useful for traders as the rate of interest is charged on the amount actually utilised by him. Such amount drawn over and above the balance to the traders credit is called an overdraft and is quite frequently used by business community in our country.

LOAN ACCOUNT :

Through another method, a certain sum is advanced by debiting the amount to a 'loan amount' and crediting the customer's account with the same amount. The rate of interest fixed through mutual agreement is charged on the whole sum stipulated to be borrowed not with standing the amount actually withdrawn.

SECURITIES FOR LOANS :

A bank will seldom grant a loan except against a reasonable security and with a good margin to allow for contingencies. The banks generally advance loans on different types of securities mentioned below :

(i) Goods : Bankers advance loans to the traders on the security of goods, agricultural products and documents of title of goods.

(ii) Documents of Title to Goods : Banks usually advance loans against the security of documents of title to goods. The more important documents are (i) Bills of lending (2) Dock warrants, (3) Railway Receipts, (4) Delivery orders, and (5) Ware-house receipts. Where documents of title to

goods are accepted as security, the customer may deliver them to the banker together with a letter of hypothecation acknowledging the banker's title to the goods and his right to dispose them of if the customer fails to repay the loan on maturity.

HIRE-PURCHASE SCHEME :

A notable feature during these years is the introduction of schemes of providing hire-purchase finance by the bankers. Indian banks now provide hire-purchase finance for purchasing consumer durables. The customer has to deposit a small portion of the price in cash with the bank. The bank them pays the dealer in full after which the article is delivered to the customer.

POLICIES OF THE RBI :

The Reserve Bank of India has wide powers of control over advances of banking companies under Section 20 of the Banking Regulation Act (1949). Under Section 21 of the same legislation the RBI may give directions to banking companies in general, or to any banking as to the purpose for which advances may or may not be given, the margins to be maintained in respect of secured advances and rates of interest to be charged on such loans. Thus the banks can make advances under strict directions and control of the central banking authority.

In addition to assisting traders indirectly through personal or hire-purchase the banks, loans render valuable assistance to wholesale and retail trade directly. The traders usually need finance for maintaining a particular level of inventories and replenishing their stocks from time to time.

B. Finance for small business entreprenuers :

During 1969 commercial banks introduced various schemes for financing small business covering the entire spectrum of retail trade as also individuals in specialised professions where the value of movable equipment, present or future (after their acquisition of these assets from the commercial banks finance) does not exceed Rs. 1 lakh. Advances are granted for meeting the working capital and equipment needs.

The most common form of advance to trade is against merchandise which is either pledged or hypothecated to the lending bank. In this context, the provision of sufficient storage accommodation acquires special significance. Unfortunately, this problem has not received due priority and attention in the country and there is very great scarcity of warehousing facility.

On the otherhand in absence of a well organised agency up-to-date information about the financial position and business standing of individuals and firms has been very seriously felt. Due to this deficiency merchants find it difficult to obtain their due share in credit advanced by banks in India.

It need be noted that unless commerce gets its due share in banking credit, industries may not prosper. 'It will be an act of folly' says Mr. Cooper, to choke and throttle the flow of credit to trade and commerce and at the same time except industry to thrive and the general economy to prosper. So far as private trading exists, no prudent person would advise to deny credit to trade and commerce by banking institutions.

8.7 SELF-EMPLOYEES AND PROFESSIONALS :

Loans to professionals and self-employed persons include loans for the purpose of purchasing equipment, repairing of renovating existing equipment and / or acquiring and repairing business

premises or for purchasing tools and / or for working capital requirements to medical practitioners including Dentists, Chartered Accountants, Cost Accountants, Lawyers or Solicitors, Engineers, Architects, Surveyors, Construction Contractors or Management consultants or to a person trained in any other art or craft who holds other a degree or diploma from any institution established, sided or recognised by Government or to a person who is considered by the bank as technically qualified or skilled in the field in which he is employed. The term also includes firms and joint ventures of such professional and self-employed persons. This category will include all advance granted by the bank under special schemes, if any, introduced for the purpose. Only such professionals and self employed persons whose borrowings limit do not exceed Rs. 2 lakhs and who are eligible for DICGC cover should be covered here.

8.8 TRANSPORT OPERATORS :

One of the important categories of priority sector lending is financing small road transport operators (SRTOs). Banks provide finance for purchasing transport vehicles to these who have experience in this line of Trade and commercially viable scheme to run the same.

Road transport operators, owning not more than six vehicles (including the one proposed to be financed) constitute one of the important beneficiaries included for bank assistance under the 20 Point Programme. The operators get priority in the allocation of bank credit for the purchase of vehicles, the acquisition of spares, for repairs of a major nature as well as for working capital purposes. The term vehicles here includes trucks, buses, taxis and auto-rickshaws used for carrying passengers or goods for hire. Security for loans upto and inclusives of Rs. 25,000 is by way of pledge / hypothecation / mortgage of the vehicles purchased out of the loan. No collateral security or third party guarantee is asked for. Banks may extend the period of repayment or reschedule the repayment programme in respect of the transport vehicles damaged or destroyed in riots and similar disturbances.

GUARANTEE COVER :

The loans provided by banks to an individual or an association of not more than six individuals owing and normally operating by himself themselves a transport vehicle for carrying goods or passengers for hire are eligible for guarantee cover by the DICGC to the extent of 75 percent of the amount in default or Rs.75,000. Which ever is lower. Credit can be extended for the cost of vehicles, spares, taxes, insurance and registration fee in connection there with, repairing and renovating the vehicles, and working capital requirements. But advances given for the replacement of vehicles damaged or destroyed in riots are treated as fresh advances for the purpose of gurarantee cover, subject to the ceiling of Rs. 75,000 on the DICGCs claim liability. In such cases, the interest applied to original advances is not allowed to be included in the computation of claim amounts. To get a guarantee cover, banks are required to obtain, inrespect of all the vehicles hypothecated to them, a comprehensive insurance cover, for risks arising from riots, strikes and similar disturbance.

REFINANCE FROM IDBI :

For loans granted to transport operators, banks can get refinance upto 75 percent from the Industrial Development Bank of India (IDBI) at an interest of 9 percent for two vehicles and 11.5 percent for more than two but less than six vehicles. The IDBI has stipulated a minimum contribution of 15 percent by borrowers (other than operators holding national permits who are not required

make any initial contribution) towards the cost of vehicles and the repayment period of four years with a moratorium of six months. Refinance for loans upto Rs. 5 lakhs granted to small operators is provided under the Automatic Refinance Scheme (ARS) on the basis of loan appraisals made by banks; there is no minimum limit for the amount of loan for the purpose of refinance. All loans which do not conform to the requirements of the scheme, as well as loans above Rs. 5 lakhs, are considered by the IDBI under its Normal Refinance Scheme.

FINANCING ROAD TRANSPORT CORPORATION :

RTCs are public utility services concerns catering to the passenger transport needs of the public who cannot afford to own vehicles and for whom the bus travel will be very cheap compared to the other modes of travel. Thus, RTCs serve a priority purpose of helping the common man in each state enabling him to travel with cost which is within Priority Sector in extending credit lines to them. Only advances to small road transport operators owing a fleet of vehicles not exceeding 6 vehicles including the one proposed to be financed will come under the Priority Sector.

The investment decision in the case of RTCs will be for deployment of funds undertakings to commercial expenditure for fixed assets or for current expenses by way of working capital. The credit assistance to RTCs are governed by the instructions of the Reserve Bank of India to Banks.

On 5th May 1982, following requests from RTCs & other public transport undertakings to commercial banks for term loans to finance their capital expenditure, the RBI has advised the banks that their role would continue to be marginal. This is because RTCs are capital heavy undertakings and banks with short term resources cannot lock up large funds in the fixed assets of RTCs for 5 to 7 years.

In the case of RTCs, the current liabilities as short term funds are minimum in view of daily collections such as from sale of tickets; contract services, passengers luggage, parcel service, postal mail services, hiring private vehicles etc., which will be substantial to take care of the current needs on day to day running expenses and stores.

The RBI has directed the banks that their lending to RTCs should be restricted to purchase of bus charges, reasonable quantity of spares and for body building. Banks should extend financial assistance for purchase of loan for bus depots, construction of bus sheds / depots which are in the nature of infrastructure. Repayment period of loans granted by banks should not normally exceed 5 years and in no case 7 years.

From the above, it is clear that banks will come to the resource of RTCs as a lender of the last resort and marginally.

8.9 EDUCATION AND OTHERS :

Education which assumes a place of predominance in the Human Development and Nation Building has been accorded a place of priority by commercial banks. Much attention is being paid to this segment in the post reform era. The commercial Banks lending to Education is guided by the RBI guidelines. As per the guidelines education loans are advanced both for studies in India and abroad the eligible courses are :

a) Studies in India :

School education including plus two stage, graduation and post-graduation courses including doctoral level Ph.D. courses, Professional courses like Engineering, Medicine, Agriculture, Veterinary,

Law, Dental, Management, Computer Courses, ICWA, C.A., C.F.A., courses conducted by IIM., I.I.T., XLRI, NIFT etc,. are eligible for educational loans.

Courses offered in India by reputed foreign universities, evening courses of approved institutes courses leading to diploma / degree etc., conducted by UGC / Govt. / AICTE / AIMS / ICMR etc., courses offered by National Institutes and other reputed private institutions are also covered under the scheme.

B. Studies Abroad :

Both graduation and Post-graduation and other job oriented professional / technical courses offered by reputed universities.

Student Eligibilities :

A student to be eligible for education loan he / she

- should be an Indian National
- should have completed previous qualifying examination
- should have secured admission to professional / technical courses through entrance test / selection process
- should have secured admission to foreign university / institution.

Expenses Eligible for Finance :

The following expenses only are eligible for financing by commercial banks :

a) Fee payable to college / school / hostel / examination including library and laboratory fee.
b) Cost of books, equipment, instruments, uniforms etc.,
c) Caution deposit, building fund, refundable deposit supported by institution bills, receipts etc.
d) Travel expenses, passage money for studies abroad.
e) Purchase of computers essential for completion of course.

QUANTUM OF FINANCE AND MARGIN :

The maximum quantum of loan for studies in India is Rs. 7.50 lakh whereas it is upto Rs. 15 lakh for studies abroad.

For education loan upto Rs. 4 lakh no security is stipulated. For a loan above Rs. 4 lakh 100% security of the loan amount or third party guarantee by a guaranteer with a networth of 100% loan amount is required. Upto a loan amount of Rs. 4 lakhs margin money is dispensed with. But if it is above Rs. 4 lakhs 5 percent is the margin money for studies in India and it is 15 percent for studies abroad.

RATE OF INTEREST AND REPAYMENT :

The repayment of education loan is scheduled to start after one year of course completion or 6 months after getting job whichever is earlier. The loan is to be repaid in 5 to 7 years after commencement of repayment.

The guidelines of the RBI stipulate 11 percent interest rate upto Rs. 4 lakh and 12 percent for a loan above Rs. 4 lakhs. The interest is to be debited at quarterly rests on simple basis during the repayment holiday.

8.10 PERFORMANCE OF COMMERCIAL BANKS IN PRIORITY SECTOR LENDING :

Priority sector credit broadly covers three sub-sectors., viz., agriculture, small-scale industries and other priority sector. The details of priority sector advances extended by the PSBs during 1994 to 2000 is presented in Table 1. It is evident from the table that the amount of priority sector credit extended by the PSBs increased from Rs. 53,197 crores as on March 1994 to Rs. 1,27,807 crores as on March 2000 (increased by Rs. 74,610 crores) . In terms of share of PS credit to NBC, it was 37.8 percent in March 1994, which increased to 43.6 percent in March 2000 (an increase of 5.8 percent). Agriculture (direct and indirect) advances of the PSBs increased from Rs. 21,205 crores as on March 1994 to Rs. 46,190 crores as on March 2000. The increase in absolute amount however, has not reflected in terms of percentage share of PS advances of NBC. For example, it was 15.1 percent as on March 1994, which increased to 15.8 percent as on March 2000. The share of SSI advances to NBC of the PSBs remained around 15 percent in 1994 and 1995. The share of SSI sector was marginally increased in the subsequent years and stood at 17.3 percent in March 1999. However, it got reduced to 15.6 percent as on March 2000. The share of Other Priority Sector (OPS) credit to NBC has been continuously increasing (7.4 percent in March 1994 to 10.9 percent in March 2000) over the reference years as can be seen from Table - 1.

Table - 1

Priority Sector Advances of the Public Sector Banks (1994 to 2000)

(Amt. in Rs. Crores)

		of which (PS)			
Year Ending March	Net Bank Credit	Priority Sector Credit	Agriculture	Small Scale Industry	Other Priority Sectors
1994	140914	53197 (37.8)	21205 (15.1)	21561 (15.3)	10432 (7.4)
1995	169038	61794 (36.6)	23513 (13.9)	25843 (15.3)	12434 (7.4)
1996	184391	69609 (37.8)	26351 (14.3)	29482 (16.0)	13751 (7.5)
1997	189684	79131 (41.7.)	31012 (16..3)	31542 (16.6)	16548 (8.7)
1998	218219	91319 (41.8)	34305 (15.7)	38109 (17.5)	18881 (8.7)
1999	246203	107200 (43.5)	40078 (16.3)	42674 (17.3)	24448 (9.9)
2000	292943	1,27,807 (43.6).	46190 (15.8)	45788 (15.6)	32080 (11.0)

Source : Reports on Trends and Progress of Banking in India for 1995-96 to 1999-2000 data is provisional.

Note : Figures in brackets represent percentage to Net Bank Credit.

8.11 PROBLEMS OF PRIORITY SECTOR LENDING

The initial enthusiasm in favour of priority sector lending wanted because of the following problems faced by the banking sector.

1) As the priority sector loans were small accounts, the commercial banks were not able to monitor the distribution, follow-up and recovery of tiny loans. This increased their costs on the one side and adversely affected their profitability, on the other.
2) The banks. had to extend credit to priority sectors at low concessional rate of interest. This affected their profitability and many of the banks incurred huge losses.
3) The bank lending to priority sector was not uniform in all the states. Actually, it was quite low in many backward states like Uttar Pradesh, Bihar, Rajasthan, etc. In order to attain 40 percent of the target of the country as a whole, the banks were stepping up their loans to the priority sector in the more advanced states. This has further deteriorated the regional imbalance in the country.
4) In many cases, banks went in for indiscriminate lending in their anxiety to reach the target of 40 percent. Moreover, there was external pressure too on the banking sector to lend to weaker sections.

A close examination of the disbursal of bank credit reveals that even amongst the various regions of the country there is incongruity in the advancing of loans to the priority sector. Though, there has been a break through in branch expansion, deposit mobilization and advances to priority sectors, our commercial banks have not been adequately effective in transforming it to the benefits of the weaker section in rural areas. The traditional practices in lending, the influence of vested interests and the rampant corrupt practices are the social vices responsible for this situation.

ACTIVITY A

Write out a more of your opinion on the recommendation of Narasimham Committee to restrict priority sector lending to 10 percent and also on the rational behind the government denying that

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....
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....
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....

8.12 CONCLUSION

The unit should have helped you realise the genesis, significance and areas of priority sector lending besides the policy developments with regard to priority sector lending by commercial banks in India. Though the philosophy of priority sector credit is praiseworthy the commercial banks face a number of problems in this area of credit. Since then a paradigm shift took place in this regard with the reflections of Narasimham Committees recommendations.

The unit has also helped you understand the schemes in different identified areas of priority sector lending.

8.13 SELF - ASSESSMENT TEST :

a) Take each of those objectives listed in the beginning of the unit and regard it as a question. Working from memory, write not more than two pages on each so that you can asses whether you can recall the main points covered in this unit.
b) Explain the policy changes regarding priority sector lending by commercial banks.

8.14 FURTHER READINGS :

Krishna Swamy Working Group, *Report of the Working Group on priority sector lendings; Role of Banks,* Reserve Bank of India, Mumbai.

Vasant Desai, *Indian Banking - Nature and Problems,* Himalaya Publishing House, Mumbai.

Rama Chandra Rao, B. *Current Trends in Indian Banking,* Deep and Deep Publications, New Delhi.

Lesson - 9

NABARD AND EXIM BANK

OBJECTIVES :

Having gone through the unit you should be able to :

- comprehend the origin and objectives of the said two Development Banks
- Analyse the structure, organisation and functioning of the NABARD and EXIM Bank separetely

STRUCTURE :

9.1 NABARD - origin and objectives
9.2 Capital and organisation
9.3 Functions of NABARD
9.4 Assistance Sanctioned and Disbursed
9.5 Financing the Informal Sector - NABARD's Role
9.6 Rational and sources of Export Finance
9.7 Financing of Export - Import Trade by Commercial Banks
9.8 Genesis and objectives of EXIM Bank
9.9 Capital
9.10 Schemes of Assistance and operations
9.11 Functions of the EXIM Bank
9.12 Diversification
9.13 Assistance Sanctioned and Disbursed
9.14 Summary
9.15 Self - Assessment Questions
9.16 Key words
9.17 Further Readings

9.1 NABARD - ORIGIN AND OBJECTIVES :

National Bank for Agriculture and Rural Development (NABARD) was established in 1982, following the acceptance of recommendation in this behalf contained in the interim report of committee to Review Arrangements For Institutional Credit for Agricultural and Rural Development (CAFRICARD), constituted by the RBI in consultation with the Central Government in 1979. The Bill for setting up the institution was passed by the parliament in December 1981 and the NABARD came into existence on July 12, 1982.

The committee which recommended the establishment of NABARD hereafter referred to as 'the Bank' envisaged that the new Apex Bank would be an organisational device for providing undivided attention, foreceful direction and pointed focus to the credit problems arising out of the integrated approach to rural development. The Committee recommended that the new Bank would take over from the Reserve Bank the over seeling of entire rural credit system, including credit for rural artisans and village industries, and the statutory inspection of cooperative banks and Regional Rural Banks (RRB's) on an agency basis, RBI continuing to retain its essential controls. The committee envisaged the role of the RBI as one of spawning, fostering and nurturing the new bank in much the same way as it did earlier in the case of the Agricultural Refinance and Development Corporation (ARDC).

NABARD is an Apex Development Bank in the country for supporting and promoting agriculture and rural development. As per preamble to the Act the Bank has been established for providing credit for the promotion of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas, and for matters connected there with or incidential thereto.

9.2 CAPITAL AND ORGANISATION :

The paid-up capital of NABARD is Rs. 100 crores contributed equally by the Government of India and RBI. The other funds include : a) Internal : Short-term General Line of Credit from RBI, National Rural Credit (LTO) Fund, National Rural Credit (Stabilisation) Fund, Issue and sale of bonds and debentures guaranted by Central Government, Borrowings from Central Government and any other organisation approved by the Central Government. b) External Borrowings through Government of India: World Bank Group, other countries like U.K. West Germany, Switzerland, Netherlands, Canada, Co-financing with World Bank Group.

NABARD is managed by a Board of Directors comprising of 15 members and consists of Chairman, Managing Director, two experts in Rural Economics, three experts from Cooperative and Commercial Banks, three sitting directors from the Board of RBI, three directors from Government of India and two members representing the State Governments. The Board of Directors can constitute an Advisory Council.

9.3 FUNCTIONS OF NABARD :

On its establishments the Bank has taken over the entire undertaking of the ARDC (Argiculture and Rural Development Corporation) and has taken over from the RBI its refinancing functions in relation to the State Cooperative Banks (SCBs) and the RRBs. The Bank is now a co-ordinating agency in relation to the Central Government, Planning Commission, State Governments and Institutions at all-India and State level engaged in the development of small-scale industries, village and cottage industries, rural crafts, etc., for giving effect to the various policies and programmes relating to rural credit. The Bank is jointly owned by the Reserve Bank and the Central Government.

The primary functions of the NABARD include :

1. Credit functions
2. Developmental functions
3. Regulatory functions

1. Under the umbrella of credit functions it provides 1) short-term credit to State Co-operative Banks (SCB's), Regional Rural Banks (RRBs) and other financial institutions approved by the Reserve Bank, 2) Medium-term credit to State Co-operative Banks (SCBs), State Land Development Banks (SLDBs), Regional Bank, 3) Long-term credit to State Land Development Banks (SLDBs), Regional Rural Banks (RRBs), Commercial Banks (CBs), State Co-operative Bank (SCBs) and other financial institutions, normally SCBs and RRBs for conversion and rescheduling of loans under conditions of drought, famine or other natural calamities, military operations, enermy action etc., 5) Financing cottage / village / small-scale industries, etc., located in rural areas are also eligible for refinance from NABARD.

2. Under developmental functions NABARD co-ordinates operations of rural credit institutions, ensures institution building to improve absorption capacity of the credit delivey system, develops expertise to deal with agricultural and rural problems, assist Government, RBI and other institutions in rural development efforts, acts as agent to Government and RBI in transaction of business in relevant areas, provides facilities for training and research and dissemination of information in rural banking and development, assists State Governments to enable them to contribute to the share capital of eligible institutions, provides direct loans in cases approved by Central Government.

3. The Regulatory Functions are also wide and consist of the following :

1) The Banking Regulation Act., 1949 empowers NABARD to undertake inspection of RRBs and co-operative banks (other than primary co-operative banks).

2. Any RRB or co-operative Bank seeking permission of RBI for opening branches, etc., will have to obtain the recomendation of NABARD, i.e., application is required to be routed through NABARD.

3. RRBs and Co-operative Banks are required to file returns and documents with the NABARD in addition to the Reserve Bank under certain sections of the Banking Regulation Act, 1949.

9.4 ASSISTANCE SANCTIONED AND DISBURSED :

Table - 1 presents the Financial Assistance Sanctioned and Disbursed by NABARD during 1991-92 to 2001-02. During all the years under reference sanctioned Assistance has been completely disbursed. The assistance sanctioned by NABARD which was Rs. 363.1 crores during 1991-92 experienced an incessant increase and stood at Rs. 1896.6 crores by 2001-02.

Table - 1

Financial Assistance by NABARD 1991 - 92 to 2001 - 02

(Rs. in Crores)

Year	Sanctioned	Disbursed
1991 -1992	363.1	363.1
1992 -1993	429.3	429.3
1993 -1994	581.0	581.0
1994 -1995	674.8	674.8
1995 -1996	684.7	684.7
1996 -1997	891.3	891.3
1997 -1998	924.8	924.8
1998 -1999	1052.8	1052.8
1999 -2000	1182.4	1182.4
2000 -2001	1412.5	1412.5
2001 -2002	1896.6	1896.6

Source : Economic Survey 2002 - 03.

9.5 FINANCING THE INFORMAL SECTOR - NABARD'S ROLE :

The National Bank for Agriculture and Rural Development (NABARD), as an apex development bank, has been playing a catalytic role in the development of the informal sector in rural areas, primarily addressing the issues of (i) facilitating access to financial services and thereby accelerating the flow of institutional credit to the informal sector, (ii) building entrepreneurial and technical skills of the rural poor, (iii) facilitating market linkages and (iv) improving the productivity of agriculture in dryland areas, which sustain the largest proportion of the rural poor, through watershed development.

Micro finance approaches evolved and implemented by NABARD in recent years have demonstrated that some of the problems faced by the informal sector could be effectively addressed.

The high level of dependence of the informal sector on non-institutional sources continued despite a rapid growth of banking network in India in the last five decades.

Research studies conducted by NABARD indicated that the most important and immediate banking needs of the poor, in the order of their priority were

- opportunities to keep safe their occassional small surpluses in the form of thrift.
- Access to consumption loans to meet emergent needs and
- Hassle-free access to financial services and products, including loans for micro-enterprises.

Viewed against this demand, there were serious limitations on the supply side, as the existing products and services of the banking system were largely meant for a different type of customer segment.

In the midst of the apparent inadequacies of the formal financial system to cater to the needs of the rural poor despite its phenomenal physical outreach, and with the active support and patronage of some NGO's, an informal segment comprising small, indigenous Self-Help Groups (SHGs) had started mobilising thrift and savings of their members and lending these resources among their members on a micro scale.

This prompted NABARD to conduct action research to study the functioning of SHGs and possibilities of collaboration between banks and SHGs in the mobilisation of rural savings and improving the delivery of credit to the poor. These experiments the showed that the existing banking policies, systems and procedures, and deposit and loan products were perhaps not well suited to meet the most immediate needs of the poor. It also appeared that what the poor really needed was a better access to these services and products, rather than cheap subsidised credit. These research studies led NABARD to develop the Self Help Group (SHG) - Bank linkage approach as the core strategy that could be used by the banking system in India for increasing their outreach to the poor. The strategy involved forming SHGs of the poor, encouraging them to pool their thrift regularly and using the pooled thrift to make small interest bearing loans to members, and in the process learning the nuances of financial discipline.

NABARD saw the promotion and bank linking of SHGs not merely as a credit programme but as part of an overall arrangement for providing financial services to the poor in a sustainable menner and also an empowerment process for the members of these SHGs. It launched in 1992, a pilot project on linking 500 SHGs with banks with the active policy support of the RBI. The banks were permitted by the RBI to open savings bank accounts of informal SHGs. Steady progress of the pilot

project led to the main streaming of the SHG - Bank Linkage Programme in 1996 as a normal lending activity of the banks with widespread acceptance and treating their lendings to SHGs as part of priority sector lending.

Starting with the NABARD led limited scale pilot project in 1992, that aimed at promoting and financing 500 SHGs across the country, the SHG - Bank Linkage strategy has come a long way. With more than 4.61 lakh SHGs covering 78 lakh rural poor houeholds financed by banks with credit of over Rs. 1,026 crores and NABARD refinance of Rs. 796 crores by March 2002, the SHG-Bank Linkage Programme has emerged as the largest micro finance programme in the world. Over 17,000 bank branches of 44 Commercial banks, 191 Regional Rural Banks (RRBs) and 209 DCCBs were involved in financing these groups. Repayments by members to SHGs have been excellent and on-time repayments have covered around 98 percent. Similarly, the on-time loan repayments by SHGs to banks are over 95 percent.

The key interventions designed, implemented and funded by NABARD included (i) massive human capital development exercise aimed at awareness building and training of banks, NGOs, government development agencies and SHGs. (ii) supporting large scale promotion of quality SHGs, (iii) documentation, monitoring and dissemination of the progress and best practices. Under its various training programmes, by now, 49,700 bank officials, 10,000 NGO staff, 14,000 staff of government agencies and 1,30,000 SHG leaders have been covered. For leveraging larger loans, NABARD continues to extend 100 percent refinance to banks at attractive terms.

In addition, to facilitate graduation of the poor to micro enterprise stage, NABARD supports programmes at skill upgradation, enterpreneurship development and marketing of the produce.

NABARD looks at the future of its micro finance interventions from the perspective of (i) strengthening the existing institutional set up of rural financial institutions by marketing efficient tools of banking with the poor, thereby enpanding their outreach on a large scale, and (ii) creating a conductive and supportive environment for encouraging and supporting new MFIs (Micro financial Insitutions) graduation of exisitng NGOs into MFIs for bringing the gaps in delivery of financial services. In pursuance of the first expectation, NABARD set for itself an ambitious mission of providing access of micro financial services to one third of the rural poor through linking ten lakh SHGs with the banking system by the year 2008.

9.6 RATIONALE AND SOURCES OF EXPORT FINANCE :

Exports play an important role in the economic development of a country. This is particularly true in a developing country like India, where exports are essential to pay for the imports of capital equipment, raw-materials, technical know-how etc. needed to expedite industrial development. Indeed, expansion of export may well be described as an integral part of the development process, neglect of which can only be at the peril of development itself.

One of the essential pre-acquisities for the expansion of exports is the provision of finance. Extension of credit increasingly recognised as an effective instrument of export promotion all over the world. Export credit is primarily intended to 1) assist exporters in processing and production of goods, 2) provide liquidating to exporters to enable them to offer matching credit terms to oveseas buyers, and 3) Improve the price competitiveness of exports in foreign markets. Having realised the importance of exports credit, the government has put it in the priority sector for the lending by

Commercial banks. The various sources for export credit in India are Commercial banks, the RBI, Export Credit and Guarantee Corporation (E.C.G.C.), Export-Import (EXM) Bank, Government, State Financial Corporation etc.

9.7 FINANCING OF EXPORT AND IMPORT TRADE BY COMMERCIAL BANKS :

The financing of export trade in the pre-independence period was mainly done by the exchange banks. But after independence, it was entrusted to the commercial banks along with exchange banks.

After Independence, many attempts have been made by the Reserve Bank of India, the Government of India, and other agencies to provide sufficient flow of short, medium, and long-term capital to exporters through commercial banks. In 1957, the Export Credit and Guarantee Corporation (formerly the Export Risk Insurance Corporation) was established to facilitate the task of the lending institutions. In 1958, the Bill Market Scheme was midified to include export bills. Under the modified scheme the eligible scheduled banks were allowed to borrow against the export bills at the bank rate. In 1959, the banks were given the option of either requiring the parties to cover the exchange risks or requiring them to maintain in the loan accounts a margin of not less than 25 percent of the export bills drawn in a foreign currency and held as security in the relating loan accounts. But in 1961, the scheme was withdrawn and the matter was felt to the discretion of the banks concerned. On the recommendation of the Study Group on Export finance appointed by the Ministry of Commerce and Industry. In September 1982, the RBI Act was amended and it was allowed to buy and rediscount export bills maturing upto 180 years.

In 1965, the Pre-shipment Credit Scheme or Export Bills Credit Scheme was introduced by the RBI. At the same time, a refinancing scheme of medium-term export credits with a maturity of over six months but not exceeding five years was introduced for the benefit of the commercial banks and exporters. A Buyer Scheme was also introduced in 1973 for granting credit directly to the foreign importers of Indian capital goods. The Bills Market Scheme was introduced again for packing credit in 1967. At the same time, the Export Bills Credit Scheme was also extended to currencies other than rupee. In 1975, a Standing Committee on Export Finance was set-up. The main function of the committee was to deal with the problems which might arise in the matters of export financing by banks from time to time.

In order to further help the exporters, the advances against duty draw back scheme was introduced by the RBI in February 1976. In 1980, the Government of India approved the setting up of the Export Import (EXIM) Bank, primarily to take over all the functions relating to export-import financing by IDBI. The bank is expected to serve as a focal point for all aspects of export credit and to give special attention to the needs of exporters.

The RBI has recently directed the banks in the country that they should deploy atleast 10% of their net bank credit to the export sector.

TYPES OF EXPORT CREDIT :

Under the Foreign Exchange Regulation Act 1949, only the licensed commercial banks are permitted to deal with the foreign exchange business. Such banks are known as authorised dealers. Commercial banks generally provide three types of loans of exports based on the period of credit, namely;

1) Short-term credit, for less than 180 days,
2) Medium-term credit from 180 days to five years, and
3) Long-term credit beyond five years

The medium-term and long-term credits are given for the export of capital goods and equipments, turnkey projects, etc.,

Export credit may also be classified on the basis of the stage at which it is provided, viz., pre-shipment and post-shipment credit. Some of these loans are given independently while others are given in collaboration with other institutions.

SHORT-TERM CREDIT :

Short-term export credit is for a period not excedding 180 days and may be extended by a single bank or jointly with other banks and / or institutions. It may be pre-shipment or post-shipment in nature :

1) Pre-Shipment Short-Term Credit :

Pre-shipment short-term credit is generally provided by commercial banks in the form of 'Packing credit'. Any finance made available to exporters prior to the actual shipment of good falls under the category of pre-shipment credit. This credit is basically working capital requirement by exporters for processing / manufacturing / procuring / packing of goods meant for exports. Normally pre-shipment credit is available only upto extent of the value of the export order. At times, however, this may also exceed the value of the export order.

The conditions usually stipulated by banks for the pre-shipment creditors as follows :

i) letter of credit or firm export order should normally be lodged with the banks.
ii) The pre-shipment advance availed of should normally be liquidated by the proceeds of the relative export-bill.
iii) The pre-shipment advance availed of should normally be repaid within a maximum period of 180 days.

While extending export finance, the factors which weight with banks are the integrity of the borrowers, his experience in the field of exports, his financial position, the order he has on hand, expected orders, his past performance, his capacity not only to manufacture and supply quality goods as per contract, but also to adhere to the delivery schedule, etc., The borrower would also be expected to provide a reasonable margin representing his stake in the export business.

ii) Post-Shipment Short-Term Credit :

Short-term credit is also provided by commercial banks to exporters for the period between actual shipment goods and realisation of the payment. This credit is called the post-shipment short-term credit. This is generally provided by discounting export bills drawn on foreign buyers. After the final payment of the bills abroad by the drawers, the proceeds are applied towards the post-shipment credit.

Another field where post-shipment credit facilities are required by exporters and are being extended by banks is the financial incentive receivable from the government and other agencies. It takes nearly three to six months in the settlement of such incentives. Many concerns, particularly the

smaller ones, may not have the financial resources to carry such receivable on their books for such a long time. Normally, the claim papers for export incentives are required to be routed through the financing banks which will appropriate the proceeds when received to liquidate the advance.

Medium and Long Term Credit :

Medium term export credit is extended for a period from 180 days to five years while logn-term credit is for more than five years. These credits, both at the pre-shipment and post-shipment stages are allowed wherever deferred payments as specified by Exchange Control Department are involved. Credit may be offered between 180 days to 5 years for the specified capital and producer goods, but for consumer and other engineering goods, shorter term credit is allowed. Credit for turn key jobs and other similar projects is determined on the merits of each case. For availing the credit facility, payments equivalent to atleast the foreign exchange outgo of the contract should be received in advance.

Pre-shipment credit for medium and long-term is allowed by banks against a contract and / or letter of credit. Post-shipment credit is given either directly by a commercial bank or in collaboration with the EXIM Bank. This is made available directly by banks if it is upto Rs. One Crore in value subject to certain minimum conditions as prescribed in the guidelines.

To summarises the above, basically export finance can be categorised into two heads viz., pre-shipment finance and post-shipment finance. As the words indicate pre-shipment finance is granted prior to the shipment of goods and post-shipment finance is granted after effecting shipments on the basis of the relative documents produced.

I. Pre-shipment finance :

1. Packing credit
2. Advance against cash incentives
3. Advance against Red clause letter of credits
4. Foreign Currency Pre-shipment Credit Scheme.

II. Post-shipment finance :

1. Foreign bills purchased / discounted
2. Advance against foreign bills for collection
3. Advance against cash incentives
4. Advance against duty drawbacks
5. Advances against undrawn balances
6. Advance against International price reimbursement (IPRS) Claims
7. Post-shipment credit in Foreign Currency (PSCFC)

ELIGIBILITY FOR EXPORT FINANCE :

1. All the exporters seeking funds from the banks must possess an exporter code number issued by RBI as also an import-export code number issued by the Joint Controller of imports and Exports.
2. The exporter should be in possession of valid export orders or letters of intent etc.
3. The exporter should not be in the ‘Special Approval’ list or caution list of ECGC / RBI.

4. The exporter should be able to satisfy his banker that he has the capacity to fulfill the export order within the time limit.
5. Goods intended for export must be permissible for export as per the Export Policy.

The quantum of outstanding export credit by commercial banks was Rs. 43,321 crores in 2000-2001 constituting 9.2 percent of the Gross bank credit of Rs. 4,69,153 crores. By 2001-2002 out of the gross bank credit by commercial banks 8 percent i.e. Rs. 42,978 crores was deployed to export credit.

9.8 GENESIS AND OBJECTIVES OF EXIM BANK :

The idea of having an Export - Import Bank (EXIM Bank) was mooted as early as in 1953 by the representatives of trade and industry. Later, many official and trade organisations renewed the demand for its establishment. Notable among them are the Export Credit and Finance Committee under the chairmanship of D.S. Joshi, the Mathrani Committee and the Federation of Indian Chambers of Commerce and Industry. The Indian Institute of Foreign Trade, after an illuminating study, suggested to the Government of India in 1972 to set up an EXIM Bank and ever prepared a blue print for such an institution mainly for the reason that the commercial banks which were providing export finance till then would not be able to provide it in view of the heavy responsibilities cast on them after their nationalisation in 1969. The Government was, however, not convinced of the need to have a separate institution for financing export and import trade as it was under the impression that the existing financial institutions could take care of the special needs of exports.

In 1974, another committee with members comprising of Sri Bose Mullick the then Secretary, Department of Export Production in the Commerce Ministry, Sri J.P. Das, Director of Export Assistance, Sri P.B. Satagopan, General Manager of the Export Credit and Guarantee Corporation, and Sri B. Paranjape of the Bank of Baroda was constituted to examine the proposal of setting up of an EXIM Bank in India. This Committee suggested to the Government to establish an EXIM Bank. Though the Government accepted the suggestion in principle, it was not started. After the Janata party came to power, the demand for the establishment of an EXIM Bank was once again renewed and the Janata Government Finalised the proposal.

EXIM BANK ACT :

On 17th August, 1981, the Parliament passed the Bill for setting up the long awaited Export-Import Bank of India. The preamble to the Act states :

"To establish a corporation to be known as the Export-Import Bank of India for providing financial assistance to exporters and importers, and for functioning as the principal financial institution for co-ordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country's international trade and for matters connected there with or incidental thereto".

The main features of the Act Are :

i) The Export-Import Bank will function as the principal financial institutions for financing India's international trade and for co-ordinating the working of similar institutions and will also undertake, limited development and merchant banking functions in relation to export oriented industries;

ii) The Export - Import Bank of India will be a statutory corporation fully owned by Central Government ; and,

iii) Its resources will mainly comprise of contributions from Government in the form of grants and loans, market borrowings, deposits of long-term duration from the public and short-term and long-term funds of the Reserve Bank of India.

In order to strengthen the institutional frame work for encouraging the export of non-traditional products, in the context of increasing competition in the international market for export credit, the EXIM Bank was ultimately established on January 1, 1982. As a public financial institution co-ordinating the working of institution engaged in financing export and import, it is entrusted with the responsibility of financing, facilitating and promoting foreign trade of India. Under the EXIM Bank Act, it can also finance export of consultancy and related services, assist Indian joint verntures in third countries, conduct export studies, finance export-oriented industries and provide international merchant banking services.

OBJECTIVES :

Within the frame work of the basic aim of the bank, the objectives of the Bank may be summarised as under :

1. Provision of financial technical and administrative assistance to the export-import sectors;
2. Planning, Promotion, development and financing of export oriented concerns;
3. Undertaking financing research, surverys and techno-economic studies in connection with the promotion and development of foreign trade;
4. Collection, compilation and dissemination of market and credit information in respect of international trade.

9.9 CAPITAL :

As per section 4 of the Act the authorised capital of the EXIM is Rs. 200 crores. The Central Government is further empowered to increase the said capital to Rs. 500 crores by notification. The issued capital is to be wholly subscribed by the Central Government. The Central Government has also given loan of Rs. 20 crores to the EXIM Bank. The EXIM Bank can also raise its resources by issue and sale of bonds and debentures, borrowing from the Reserve Bank, borrowing from other institutions in India approved by the Central Government, accptance of deposits and loans in foreign currency from any foreign state or from any bank or financial institution in any foreign country with the previous consent of the Central Government.

9.10 SCHEMES OF ASSISTANCE AND OPERATIONS :

EXIM Bank operates various lending programmes for the promotion of exports of engineering and capital goods and related services from India. Assistance is extended to enable Indian exporters to operate in International markets. The different schemes of assistance operated by the EXIM Bank are the following :

1. Direct financial assistance to exporters of plant, equipment, machinery and related services in the form of medium term credit for periods exceeding six months to enable exporters to extend deferred credit to the overseas buyer ;

2. Overseas investment finance to Indian promoters of overseas as joint ventures to support them in equity investments ;
3. Overseas buyers credit to foreign imports of Indian capital goods and related services ;
4. Lines of credit to foreign governments and financial institutions for import of Indian capital goods and related services to enable them. in turn, to on-lend funds to importers of Indian capital goods in their countries ;
5. Re-lending facility to overseas banks to enable them, to provide term-finance to importers for import of Indian capital goods ;
6. Re-discounting of export bills for a period not exceeding 90 days against short-term usance export bills discounted by eligible commercial banks; and
7. Re-finance of export credit to eligible commercial banks in India against their medium to long-term post-shipment credits to Indian exporters of capital goods.

Further, EXIM Bank extends non-funded assistance in the form of guarantees in foreign currencies, on behalf of Indian exporters / contractors. In favour of overseas importers / employers and banks. These guarantees are in the nature of bid bonds, advance payments and performance guarantees, retention money guarantees, and guarantees for raising finance abroad.

In 1983, EXIM Bank introduced the EXIM syndication facility under which it provides funds for export proposals and syndicate the credit risks to Commercial banks.

EXIM Bank also undertakes various non-financing promotional activities. Its merchant banking division provides various counselling services in regard to Government rules and regulations, International Law and Practices, etc. The division organises foreign currency loans on behalf of Indian exporters and also assists in designing financial packages to suit individual requirements, for project export or for a joint venture company.

EXIM Bank also provides information to Indian exporters, analyses and advises on aspects like market opprotunities, competition, prices, degree of risk in various markets, special requirements of markets and opportunities in projects funded by supra-national agencies, etc.

In respect of region-wise assistance extended by EXIM Bank in support of Indian exports, West Asian countries continued to receive the largest share followed by countries in South-East Asia and Pacific, Americas and North Africa. Industry-wise analysis of EXIM Bank's assistance reveals that construction goods and services industries accounted for the major portion followed by railway rolling stock, vehicles and transport equipment, diesel engines and pumps and earth moving machinery.

9.11 FUNCTIONS OF THE EXIM BANK :

The Main functions of the EXIM Bank are as under :

a) Granting loans and advances in India solely or jointly with commercial banks to persons exporting or intending to export from india goods including export of turn-key projects, civil construction contracts or other contracts and services including consultancy services.
b) Granting loans and advances solely or jointly with commercial banks to persons outside India for import from India of goods including turn-key projects, civil construction contracts or other contracts and services including consultancy services.

c) Granting lines of credit of govenments, financial institutions and other suitable organisations in foreign countries to enable persons outside India to import from India goods including turn-key projects, civil construction contracts or other contracts and services including consultancy services.

d) Handling transactions where a mix of government to government credit and commercial credit for exports is involved.

e) Issuing bid bonds and guarantees and other similar facilities in India or abroad solely or jointly with commercial banks on behalf of persons exporting or intending to export from India goods including turn-key projects, civil contracts or other contracts and services including consultancy services.

f) Purchasing, discounting and negotiating export bills.

g) Selling or discounting export bills in international markets.

h) Discounting of export bills negotiated or purchased by a scheduled bank, of a financial institution notified by government or granting loans and advances against such bills.

i) Granting loans and advances to a scheduled bank or financial instution notified by the government by way of refinance of loans and advances granted by it to an exporter of goods including turn-key projects, civil constructions contracts or other contracts and services including consultancy services.

j) Granting loans and advances or issuing of guarantees solely or jointly with a commercial bank for import of goods or services from abroad.

k) Granting loans and advances to a scheduled bank or a financial institution notified by the government by way of refinance of loans and advances granted by it for importing goods or services to India.

l) Issuing, confirmation, endorsing letters of credit on behalf of exporters in India, negotiating / collecting bills under letters of credit, opening of letters of credit on behalf of importers of goods or services and negotiating documents received thereunder.

m) Maintaining of foreign currency accounts with banks and correspondents abroad for purposes connected with the business of an Export-Import Bank.

n) Buying and selling of foreign exchange and undertaking such other functions of an authorised dealer as may be necessary for the discharge of functions of an Export-Import Bank.

o) Undertaking and financing of research, surveys and techno economic studies in connection with promotion and development of international trade.

p) Providing technical, administrative and financial assistance to any exporter in India or any other person who intends to export goods from India for promotion, management or expansion of any industry with a view to developing international trade.

q) The Export-Import Bank will also undertake limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of companies, engaged in export or import and providing technical, administrative and financial assistance to parties in connection with export or import. The Export-Import Bank can also undertake the developing and financing of export-oriented industries.

9.12 DIVERSIFICATION :

EXIM Bank promotes Indian exports through a variety of products and services. It has devised 24 products to meet the needs of various customer groups viz. Indian customers, overseas investors and commercial banks. The exporters can avail of pre-shipment credit, suppliers credit, overseas investments finance, export product development loans and loans for export marketing and investment vendors development finance. It also provides term investment loans to export oriented units.

Over the years, EXIM Bank has diversified its products and services and not it offers a range of products at various stages in the export cycle viz., export product development and postshipment services covering a variety of customers. Apart from finance, the Bank seeks to promote exports through information and advisory services to enable exporters to evaluate international risks, export opprotunities and competitiveness. Also, EXIM Bank and an institutional working group constituted by the Bank evalulates and approves export bids involving deffered payments and / or issue of guarantees in respect of construction, consultancy, technology services and turn-key projects. During 1992-93, EXIM Bank introduced new products of funding exporters such as Production Equipment Finance Programme, Export Marketing Finance Programme - III and Vendor Development Programme.

9.13 ASSISTANCE SANCTIONED AND DISBURSED :

TYPES OF ASSISTANCE :

The EXIM Bank broadly provides two types of assistance viz., (i) Funded assistance and (II) Non-funded assistance.

i) The funded Assistance is extended to Indian exporters to enable them to operate in the global markets. This funded assistance consists of (a) loans to Indian companies (b) loans to Foreign Governments, companies and financial institutions and (c) loans to commercial banks in India.

a) Loans to Indian Companies :

Under this head the Banks offers Direct Financial Assistance to exporting company in the form of medium term credit, technology and consultancy services, pre-shipment credit to finance export contrasts for capital goods, overseas investment finance to finance equity participation by Indian promoters of overseas joint ventures.

b) Loans to Foreign Governments, Companies and Financial Institutions :

Under this head the Bank offers different lines of credit to Foreign Governments and financial institutions for import of Indian Capital Goods and related services, relending facilities to Indian banks abroad to enable them to provide term finance for import of Indian capital goods. It also offers credit directly to foreign importers of Indian capital goods and related services.

c) Loans to Commercial Banks in India :

Two main types of loans are offered by the EXIM Bank to Commercial banks. These are :

1. Rediscounting of export bills.
2. Refinance of export credit.

II) Non-Funded assistance is provided in the form of guarantees, in association with commercial banks, on behalf of Indian exporters in favour of overseas importers and banks.

The quantum Financial Assistance Sanctioned and Disbursed by EXIM Bank during 1991-92 to 2001-02 is presented in Table - 2. As can be seen from the table the total assistance sanctioned under various schemes by the Bank during 1991-92 which was Rs. 1192.9 increased and stood at Rs. 4785.7 crores in 2001-02. The amount of assistance disbursed in 1991-92 was Rs. 1202.00 crores and by 2001-02 it increased to Rs. 3369.2 crores.

Table - 2

Financial Assistance by EXIM Bank 1991-92 to 2001 to 02.

(Rs. in Crores.)

Year	Sanctioned	Disbursed
1991-1992	1192.9	1202.0
1992-1993	1717.0	1399.9
1993-1994	737.7	914.6
1994-1995	2972.0	1639.3
1995-1996	2668.4	2303.2
1996-1997	1378.6	1404.7
1997-1998	224.3	1501.6
1998-1999	2101.5	1518.1
1999-2000	3272.1	2031.3
2000-2001	2386.1	2070.5
2001-2002	4785.7	3369.2

Source : Economic Survey 2002-03.

ACTIVITY - A :

List out your reflections on the trends and growth in Assistance sanctioned and Disbursed by (i) NABARD (ii) EXIM Bank based on the data provided in Table - 1 and Table - 2.

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9.14 SUMMARY :

This unit was meant to provide a wider understanding of the objectives, functions and operational profile of the All India Financial Institutions NABARD and EXIM Bank. Which are meant respectlively for Agriculture and Rural Development and Export - Import Financing.

It has attempted to present a wider canvas for your skill improvement in evaluating the functional performance of the said institutions objectively.

9.15 SELF - ASSESSMENT QUESTIONS :

Elucidate the origin, objectives and functions of NABARD explain the role of NABARD in Financing Informal Sector.

Explain briefly the objectives and functions of EXIM Bank construct Bars with the help of the data presented in Table - 1 and Table - 2.

9.16 KEY WORDS :

Bill of Lading : A document signed by the shipping agency acknowledging the receipt of certain specified goods for carriage and embodying an undertaking that goods will be delivered to the consignee.

Letter of Credit : An arrangement by which the obligation to pay an exporter is undertaken by bank.

ECGC : Export Credit Guarantee Corporation

9.17 FURTHER READINGS :

Vasant Desai, *Indian Banking Nature and Problems,* Himalaya Publishing House, Mumbai.

Ruddar Dutt and Sandaram, *Indian Economy,* Sultan Chand & Company Ltd, New Delhi.

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Dr. B.P. Tyagi, *Agricultural Economics and Rural Development*, Jai Prakash Nath & Co., Mearut, 1993-94.

K.C. Sekhar, *Banking Theory and Practice*, Vikas Publishing House, New Delhi, 1994.

Lesson - 10

PROFITABILITY IN COMMERCIAL BANKS

OBJECTIVES :

The Objectives of the Unit are to

- explain the concept of profitability in Commercial Banks
- understand Profitability Planning Process and Environment in Commercial Banks
- understand different aspects covered by Profit Planning in Commercial Banks.
- provide an insight into the profitability scenario of Public Sector Banks in India.

STRUCTURE :

10.1 Introduction
10.2 Concept and Measurement of Profit in Banks
10.3 Profit - Social Constraints
10.4 Profitability - A measure of efficiency
10.5 Profitability status of Commercial Banks
10.6 Need to improve profitability
10.7 Reasons for low profitability
10.8 Measures to improve profibility
10.9 Profit Planning premises
10.10 Profit Planning in Commercial Banks
10.11 Different Aspects covered by Profit Planning in Commercial Banks
10.12 Summary
10.13 Self - Assessment Test
10.14 Key Words
10.15 Further Readings

10.1 INTRODUCTION :

Since the Banking Sector Reforms is experienced in 1993, the dominat opinion is that the performance of a commercial bank is judged more in terms of profitability, efficiency, extent of customer satisfaction etc. than in terms of number of branches and quantum of deposits and advances.

Banks have experienced a number of positive policy orientation. Extention of banking facilities in rural areas, deposit mobilisation, social control of banks, service area apparoach, recent drive in the area of divesification of banking services etc., are the result of such policy reorientation. The performance of commercial banks on all these fronts was quite impressive.

The most reported deficiencies of commercial banks are in the areas of customer service, planing, profitability and viability. The functioning of Indian commercial banks are especially public sector banks is not free from such critism. No doubt the profile of the Indian banking system has undergone major changes since nationalisation with emphasis of banking shifting to national priorities and social objectives. But in order to serve effectively our national objective, besides being innovative, banks have to remain healthy and profitable. The current concern of all players in the banking system is profitability which is especially more emphasised in the post reform era.

10.2 CONCEPT AND MEASUREMENT OF PROFIT IN BANKS :

For any commercial enterprise, profit margin is the difference between income and expenditure. This applies to a bank too and the difference between income earned and expenditure incurred becomes its profit margin or net spread. The gross spread is the difference between interest earned through loans and advances and interest paid on deposits. The net spread is derived after accounting for non-interest income and non-interest expenditure including provisions for non-performing assets.

The interest spread is a measure of a banks, profitability, it gives the net returns to a bank on a deposit liabity of Rs. 100. A bank invests its deposits in CRR, SLR, priority sectors, cash and other advances.

An ideal situation where all assets are performing 100%. As this does not happen in real circumstances, the spread gets lowered, Banks have to meet their other operating expenses, like staff salaries, rents, postal expenditure, stationery and contingences out of this interest spread. To some extent, this is offset by the bank's non-advances, income, but the major percentage has still to be met out of the spread.

Profit in banks can be understood easily as below :

i) Return on investment including advances - interest paid out on deposits = Interest spread.

ii) Overheads (Operating expenses) - non-interest income (commission, discount, miscellaneous charges) = Burden

iii) Profit = Interest spread - Burden

Spread : Interest Received minus Interest Paid out :

The spread of various bank groups for three years and its ratio to total assets of the respective bank groups is presented in Table - 1.

Table - 1 Ratio of Spread to Total Assets

Banks	Spread (Rs. Crore)			Percent to total assets		
	1999-2000	2000-01	2001-02	1999-2000	2000-01	2001-02
Bank						
1. Public Sector	24040	29436	31568	2.7	2.9	2.7
(a) SBI & Associates	9283	11249	12190	2.8	2.8	2.7
(b) Nationalised	14757	18187	19378	2.7	2.9	2.7
2. Private Sector	2853	3808	4241	2.2	2.3	1.6
(a) Old	1702	2123	2231	2.3	2.5	2.4
(b) New	1151	1685	2010	1.9	2.1	1.2
3. Foreign	3250	3707	3646	3.9	3.6	3.3
4. SCBs (1+2+3)	30143	36951	39455	2.7	2.9	2.6

Source : Economic Survey, 2002-03.

ACTIVITY - A

Write your observations based on the above data presented in the table about the trend of spread

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10.3 PROFIT - SOCIAL CONSTRAINTS :

Traditionally the commercial banks, as their name indicated, were operating with commercial motive of maximising the profits in consonance with the principles of liquidity and within the parameters of its financial safety. However, 'Social forces and country's economic policies compel banks to pursue not merely profit as the supreme goal but also to promote wide social interests by financing income generating development projects'. These who have this view, advocate that as the banks have strategic importance being the largest financial institutions in an economy, and as they have public utility nature, and therefore, service motive more than profit motive must be their supreme consideration. The contribution of banks to the prosperity of a nation is more important than the profitability of a single commercial sector.

The commercial banks are entrusted with the social responsibilities also. But the wide spread emergence of this new role of banking sector seems to be incompatible with the basic principle of profitability of this business institution. It is often argued that the objectives of profitability, and social responsibility do not go together. It is further believed that the developmental goal may not fulfil the prime objective of maximising the profits.

10.4 PROFITABILITY - A MEASURE OF EFFICIENCY :

Undoubtedly, the argument in favour of developmental role of bank's is geneuine and justified. Formely the banks had purely a commercial motive without any relevance to the welfare of the community it was serving. Now the banks are compelled to play an active role in the welfare of the community but without impairing its commercial purpose.

Objective assessment of bank's, contribution to the economy is an extremely difficult task. As the indirect benefits are not quantifiable, it is problematic to work out the cost-benefit analysis for them. Moreover, when banks are dealing with demand liabilities, it is their moral obligation to follow certain basis canons regarding their business. It is obvious, therefore, that the profitability aspect cannot be ignored in measuring efficiency of banks. A balance between these two seemingly irreconcilable objectives may, therefore, have to be found.

ACTIVITY - B

Try to list out some social obligations of banks in your thinking and give your reflections with respect to reconciliation of profitability vs social obligations.

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10.5 PROFITABILITY STATUS OF COMMERCIAL BANKS :

Profits of commercial banks, after providing for taxation and bonus exgratia payment to staff, declined considerably during late seventies. The trend in declining profitability is however, not confined to public sector banks alone; but it is equally applicable to private sector banks. In the case of public sector banks, the declining trend of profitability began much prior to nationalisation and has become more pronounced afterwards.

It is a general appreciation that private sector banks show a comparatively better financial performance and viability compared to public sector banks. The smooth running of all operations of banks arises out of the trust reposed in them by million of depositors all over the country. Continued profitability alone can be the catalyst to bring about such a trust.

The profit scenario of commercial banks is presented in Table - 2 below during 1991-92 to 2002-02. It is evident from the table that though the profits of the total scheduled commercial banks showed esciallations and deplorable decline upto 1993-94, in the following years ending with 2001-02 a steady and appreciable improvement has been experienced.

Table 2 : Profit of Scheduled Commercial Banks (Rs. in Crores)

Banks	1991 - 92	1992 - 93	1993 - 94	1994 - 95	1995 - 96	1996 - 97	1997 - 98	1998 -99	2001 -02
SBI Group (8)	244	280	356	846	793	1,707	2,460	1466	3450
PSBs (19)	559	-3,648	-4,779	269	-1160	3,152	2,570	3258	8301
Private (34)	77	60	149	367	557	882	840	708	1779
Foreign (42)	320	-842	573	573	744	666	630	693	1492
Total	1200	-4150	-3701	2055	934	6407	6500	6125	11572

Source : Compiled on the basis of Reports on the Trend and Progress of Banking in India, RBI.

10.6 NEED TO IMPROVE PROFITABILITY :

Banks, as the custodians of public money, vehicles of social justice, vital organs of the economy and catalysts of socio economic development, must be able to protect their existence without dependence. They need viability through profitability. The inevitable need for the banks to maintain profitability is due to the following reasons.

Fristly, the commercial banking system is built mainly on the confidence of the general public in the capacity of the system to honour its obligations to the depositing public. The major consideration

in assessing the capacity of a banking institution or a banking system in fullfilling its obligations is the financial viability of the institution or the system. Moreover, the viability of the banking system is a basic requirement for the stability of the economy. As an empirical evidence in support of this argument, the bank failures in U.S.A. during 1920's which directly resulted in the world wide Great Depression of 1930, may be sighted. The viability of a banking institution is assessed more in terms of its profits than anything else. Hence the importance of profitability.

Secondly, the owners of the commercial banks, either private or public, should definitely be compensated, atleast in the long-run, for the cost of funds invested by them towards capital of these banks. Naturally, a question arises whether the government whcih owns the public sector banks should also be compensated. Because, the government cannot be expected to regularly and indefinitly subsidize the operations of commercial banks out of its revenues. In view of the overall objectives before the nation, it is but imperative for all the public sector undertakings including the public sector banks to put in efforts to generate adequate surpluses in their operation to supplement the finances of the government instead of expecting the government to subsidise their operations. Thus, there is a need for the public sector banks too, to maintain a reasonable degree of profitability in their operations.

Thirdly, commercial banks have to maintain profitability to meet probable future losses, about which there is little certainty. Only by gradually building up reserves from profits can any banking institution hope to insure itself against uncertain future losses.

Fourthly, continuous growth of the commercial banks in terms of deposits and advances has resulted in a rapid decline in the ratio of capital and reserves to deposit liabilities. To keep up the rating of Indian commercial banks, in international banking circles, efforts may be required to raise this ratio. This is possible only if reserves are accumulated through the enhanced profits.

10.7 REASONS FOR LOW PROFITABILITY :

To understand better the need for profit planning it is imperative to know the cause for low or declining profitability in the commercial banks. Though different in degree all the factors mentioned below are empirically observed to contribute towards low profits in banks. These are : large amount of non-performing assets, growing list of assisted units, sickness, irregular credit limits, lack of accountability, highly subsidised social lending, vitiated recovery climate, low staff productivity, high reserve requirements, unprofitable operations of rural branches, inability to upgrade technology, lack of cost consciousness, lack of sence of profitability.

10.8 MEASURES TO IMPROVE PROFITABILITY :

To sustain the profits the commercial banks have to observe and adopt the some important measures. Accent on consolidation, accent on service area branch opening, selective opening of urban / metro branches, closing down unprofitable branches, increasing coupon rates, introduction of short term instruments, strengthening of capital base, control of staff unproductivity, modernising technology, better credit management, stringent appraisal, alertness, proper end-use supervision monitoring and project follow-up, proper accountability, need for a legislation empowering banks to recover their dues, controlling non-performing assets to maintain spread, boom in capital market,

banks and FIS to act in tandem, need for change in attitudes and organisation culture and mechanisation, better customer service, aggressive marketing culture, profit planning etc.

Quest for profitability has to be central to bank's health. More than the price of service, the quality of service should matter. Therefore, customer focus, product diversification, emphasis on investment banking and non-fund based activities, derivative instruments etc., will provide a wide base for profitable banking operations in the future. Banks have to identify core competency areas and vigorously pursue niche marketing approach so as to operate profitably in the competitive financial market. Apparently, the weak banks have to concentrate on a few strategic areas to make a turn around and develop appropriate approaches as a long-term strategy for sustained profitable operations in the emerging financial system.

ACTIVITY - C

Consider the above observations related to profitability and profit scenario of banks and state some measures in your opinion to improvement of profits.

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10.9 PROFIT PLANNING PREMISES :

A close scrutiny of the causes mentioned above would show that a majority of them are beyond the control of the individual banks. But, within these constraints imposed, the commercial banks. Including the public sector banks have to maintain the profitability of the banks. Hence, the need for profit planning in commercial banks.

While talking about profit planning, we are not setting 'Profit maximisation' as the 'objective function' of the bank managements. The actual objective function of the managements of commercial banks, which is to be maximised is a joint function of performance of the bank on the fronts of (i) fulfilling such social objectives as branch expansion into hitherto neglected regions of the country and meeting the crerdit requirements of the identified priority sectors, (ii) managing the financial resources of the banks optimally, (iii) utilising the man power resources of the banks efficiently and (iv) providing satisfactory customer service. Although, quantitative measure of each one of the above activities of the banks are available a combined index is not readly available. Efforts are being made to arrive at such a composite index of performance of commercial banks. Under the given standard levels of performance with regard to fulfilling social responsibilities, the commercial banks should attempt at achieving a 'reasonable' rate of profit. Improving profitability of banks would have to be a major preoccupation. It is essential on the part of individual banks to bring about an improvement. In their internal and functional efficiency to achieve the basic goal of viability and profitability. An improvement in profitability requires better cost control, profit planning and budgeting and control of non-interest expenses on the part of each bank.

Before analysing the concept and intricacies of profit planning let us focus on the concept of planning in general. Planning is selecting information and making assumptions regarding the future to formulate activities necessary to achieve organisational goals. It is composed of numerous decisions oriented to the future. Planning is deciding in advance what is to be done. It involves the selection of objectives, policies, procedures and programs from among alternatives. Thus, planning is primarily concerned with looking into the future, involving the selection of the best alternative. The need for planning arises mostly due to the fact that modern organisations have to survive, operate and grow in highly competitive and market economies where change is the rule. With respect to Commercial banks the operations have become increasingly in an increasingly challenging in an increasingly competitive environment.

10.10 PROFIT PLANNING IN COMMERCIAL BANKS :

Planning for better performance can be attempted through planning for better profits. Profit planning in commercial banks should not be construed as a tool for maximisation of absolute profit should be understood as a technique for profit standardisation within the standard constraints imposed by much wider and laudable objectives. Such an exercise practically means planning the management of the whole gamut of operations of commercial banks. Thus, it clearly indicates that we are aiming at 'performance planning' with an eye on profitability and profit etability.

10.11 DIFFERENT ASPECTS COVERED BY PROFIT PLANNING IN COMMERCIAL BANKS :

The profit planning in commercial banks covers different aspects explained below :

a) Planning Process :

As a first setp in the planning process, the constraints are to be set up in a systematic manner. The social responsibilities, the policy guidelines of the Government and Reserve Bank of India, and also the organisational and operational restraints of a bank are the major constraints. Planning is to be confined to a reasonable period of one year, so that it would be possible to review the performance vis-a-vis the plan at the end of eachyear. However, mid-term reviews should also be conducted to avoid unexpected failure of the plans.

The resources that can be mobilised during the plan period in the form of deosits and refinance are to be forecasted. The deployment of resources to be mobilised is to be planned next on the basis of the expertise that a bank had built up in lending to various sectors and the overall policy guidelines available regarding financing hitherto neglected sections and sectors of the economy.

The plan prepared as above is to be disaggregated to the level of zones or regions. What has been described above is with reference to planning at macro level. On the basis of the plan prepared at the corporate level, individual units of operation at the micro level should prepare plans for their own units.

The methodology of planning should be uniform at both levels. By aggregating the branch plans to the regional and zonal levels and matching these plans with these obtained by disaggregating corporate plan to the regional and zonal levels, the variance, if any between aspirations of higher and

lower tiers of administration can be identified and suitable and necessary alterations can be made in the plans.

B) The Interest Spread :

The interest expenditure on resources mobilised and interest and discount income on resources deployed are to be estimated. An analysis of the composition of income and expenditure items would be revealing and would be useful in the planning process. The data pertaining to the immediately preceding year can be used by the banks to plan improved performance in the subsequent year.

By mobilising lower interest bearing deposits the average rate of interest expenditure can be reduced while changing the composition of credit in favour of higher interest bearing advances would raise the average rate of interest on advances. But the social responsibilities accepted by the banks would make changing credit flow into higher interest yielding sectors difficult. In view of this inflexibility, there is only a limited scope for planning for profits in this area.

The income from sources like commission, exchange etc., should also be augmented. The income from these sources can be augmented by popularising servicing of the commercial banks and product diversification. There is a more important advantage in popularising these services. While the 'cash float' generated by the extension of these services is at no interest cost. As a matter of fact some of these services also bring in additional incomes to the banks, in the form of commission and exchange earnings. The size of the 'float' therefore has to be enlarged by properly planning suitable strategies to market these services. Prompt service is basic requirement for being able to sell these services. Particularly, when interest rate structure is highly inflexible and the 'spread' is too narrow, the banks have to take recourse to improving profitability by increasing the 'float'. The branches should compare the ratios obtained at their level with those obtained at the macro level and plant to gradually reduce their expenditure ratios.

It would also be useful if the 'costs' and 'income' yielding capacities of various types of accounts are also estimated. These would provide an insight into the economics of operating various categories of accounts.

c) Productivity Appraisal and Improvement :

Productivity appraisal and improvement are sine quanon for profitability. The volume of business per unit of the administrative expenses should be increased. The business per employee has got to be enchanced continuously, so that the income earned on volume of business would not only cover the annually increasing expenditure on staff, the interest cost of funds and other expenses, but also leave reasonable margin of profits. Thus, for incresing the profitability of banks, the productivity of employees has to be continuously raised.

The quantitive enchancement in the productivity of employees should be accompained by a qualitative improvement in the work of the personnel. The qualitative improvement should be brought about by training the personnel in efficiently managing the responsibilities assigned to them. The

personnel of banks are required to be taken into confidence by the managements and in turn the personnel have to willingly undertake larger responsibilities of managing the operations of the banks.

The public are to be gradually educated about the importance and role of banking in economic prosperity and this can be done effectively only by the personnel of the banks. The clientele of the banks are to be persuaded to realise their responsibilities towards the banks. Only then, can the banks hope to solve the problem of mounting bad and doubtful debts. 'Customer Counselling' should become normal accepted practice. This should be done by the personnel at the field level. Customer counselling would become fruitful only when done with empathy. For this, proper training for personnel becomes a prerequisite. The training shoud aim at bringing about attitudinal changes in the employee accompanied by quantitative enhancement is bound to raise the level of profitability of commercial banks.

D) Operational and Organisational Procedures :

Operational expenditure such as expenditure on premises, stationery, furniture and fixtures should be controlled. By proper planning, it would be possible to avoid some portion of the expenditure that is being presently incurred on these items. By conducting a careful study individual banks can identify potential areas of operation for simplification of procedures and methods. The banking procedures need to be simplified. One important criteria for simplification should be cost reduction. The reduction of costs may be achieved through saving of manpower, space and stationery.

Similarly, the organisational structure of banks should also be restructed. A decentralised structure that drastically reduce the distance between the vaious 'service points' and the decision making points would reduce the costs of operation. However, such a restructing can be done beneficially only when the personnel of the banks are thoroughly trained and adequately motivated to perform their responsibilities efficiently. On the basis of appropriate objective performance appraisal, the reward and punishment system should be implemented. Under such a 'work environment'. the best in individuals is likely to come out to contribute to profits.

If the routine responsibilities are gradually delegated to junior levels, than the senior personnel can divert their attention towards more important matters of 'Policy-making' and 'innovation making' Gradually, the cost of operating such adminstrative offices as regional, zonal and head offices are to be reduced in the total costs. This will be possible by continuous deligation of decision - making authority to lower level functionaries. Hence, there is a case for periodic reorganisation of banks which would achieve greater degree of decentralisation and lower costs of operation to leave a surplus.

E. Cost of Banking Services :

Precious little have been done with regard to costing of banking services within the individual banks. Although one may have rough ideas about costs of various scheme and services, they are not sufficient for proper profit planning, exact quantitive estimates of costs of schemes and services would be extremely useful. These estimates help to provide nearly correct values of costs of various services and facilitate profit planning.

F. Rationalising Bureaucracy to Action :

Profitability is a function of managerial efficiency plus orgnisational culture. Profitability could be affected not only by non-performing assets but also by non-performing branches, non-performing human resource and cultural transformation. Undue bureaucratisation, unnecessary tiers, top heavy structures need to be rationalised for effective action, achieving cost efficinecy and overall efficiency leading to profitabiilty.

Profit planning does not connot can undue emphasis on profits. Let service to society be the primary goal of banks, necessarily followed by earning goal. Profit planning, should be a continuous periodical exercise which must be reviewed from time to time to make necessary improvements.

10.12 SUMMARY :

The unit has attempted to familiarise with the concept of spread, profits and profitability in commercial banks. Despite the social obligations of commercial banks, especially the public sector banks, commercial vaibility and profitability need a greater attention in the present competitive environment. Particularly since banking sector reforms systematic profit planing, with a clear comprehension of the profit planning environment of commercial banks is a prerequisite for grearing the entire commercial banking system towards profitability.

This unit also tried to help you to identify the reasons for low profits and develop yourself some measures to improve profitability.

10.13 SELF - ASSESSMENT TEST :

1) Briefly explain the concept and measurement of profit in banks
2) State the need for profitability in commercial banks and explain the profit status of commercial banks
3) What is profit planning ? Discuss the various aspects involved in profit planning.
4) Give an account of the trends in profitability of commercial banks in India, Does profitability a measure of performance ?

10.14 KEY WORDS :

Spread : Interest an investments including advances minus interest paid out on deposits.

Niche Marketing : Marketing or designing and orientation the products or services those markets or segments of the market which are potential lying untouched.

10.15 FURTHER READINGS :

Damley, V.B. - Profit Planning and performance budgeting in Commercial Banks.

P.V. Varde and Sampat Singh - Profitability in Commercial Banks.

Lesson - 11

HRD IN BANKS

OBJECTIVES :

After reading this unit, you should be able to :

- understand the concept of HRD and its objectives.
- understand the manpower planning and recruitment in Banks
- understand Training practices in Banks
- understand welfare and Industrial relation in commercial Bank.

STRUCTURE :

11.1 Introduction

11.2 Manpower planning in Banks

11.2.1 Steps in manpower planning in Banks

11.2.2 Recruitment and selection in Banks

11.3 Training in Banks

11.4 Welfare in Banks

11.5 Industrial Relations in Banker

11.6 Conclusion

11.7 Self-Assessment Exercises

11.8 Further Readings

11.1 INTRODUCTION :

Human Resource Development (HRD) has gained increasing attention in the past three decades from human resource specialists, training and development professionals and others.

The need of HRD for any organisation arises mainly due to the following reasons :

1) the dearth of capable managerial manpower and a greater need in the future increase the competition for available talent.
2) the continued growth and development of business, coupled with increased complexities such as the problems of size, technology and competition adds further pressurer.

Similarly, the need for HRD is more in service oriented institutions like commercial banks. An efficient and effective banking system helps the process of economic development of any nation as per its priorities. The need of the HRD in the banking institution has continuously grown because of their effective role in the socio-economic of the country. There are also high expectations of the society from the banking system, which cannot be met without the development of the integrity, efficiency and behavioural pattern of those who are working in the bank. Thus, HRD in the context of banking would mean not only the development of new knowledge and skills of the employees but also developing capabilities to meet the needs of both internal and external environment attaining self confidence and motivation for public service HRD also aims at giving more and more thrust on the human resource to encourage creativity for the better customer service. HRD efforts in banks focus on building a strong

character of honesty, integrity and truthfulness.

The HRD policy in the banks has to act as an effective instrument to encourage employees, to show creativity, to reach for excellence and finally to render better customer service.

The objectives of HRD in banks are :

- creating a climate of openess and trust
- building a collaboratiive culture whereby everyone is an important member of an effective team
- preparing individuals for technological competence
- psychological preparedness for willing to participate in change implementation
- promoting human capabilities and competencies in the organisation
- facilitating to build a strong character of honesty and integrity in performance
- helping the individual to develop his potential, realise his power so that he will be able to achieve his self goals while contributing to the success of organisation
- improving quality of work life

11.2 MANPOWER PLANNING AND RECRUITMENT IN BANKS :

Manpower planning includes plans for both the demand and supply of manpower. Manpower planning is a set of interrelated plans to ensure that the right number of employees of right type are available from within and outside at right time for right job to achieve short and long term goals of the organisation.

The objectives of Manpower planning are :

- To relate future human resources to future organisational needs so as to maximise the future return on investment in human resources
- To match employee abilities to organisational requirements, with an emphasis on future.
- To ensure optimum use of human resources currently employed.
- To assess or forecast future skills requirements of the organisations over all objectives are to be achieved
- To provide control measures to ensure that the necessary resources are available as and when required
- to anticipate redundancies and avoid unnecessay dimissals
- To determine optimum training levels, and
- To provide a basis for optimum management development programmes.

11.2.1 STEPS IN MANPOWER PLANNING IN BANKS :

The important steps in manpower planning in banks are

1) Formulation of long-range, short-range objectives, plans, programmes and budgets of banks regarding their key activities like branch expansion, soruces of mobilisation, loans and advances and other services.

Commercial banks take into consideration the long-term objectives and plans while planning for human resources relating to

- branch expansion in different areas like backward, unbanked, underbanked, rural, urban etc.,
- deposit mobilisation from different sections of the economy
- deployment of credit to priority sectors
- improvements in the quality as well as quantity of customer service
- improving the recovery performance
- educating the borrowers
- conditions / regulations to be imposed by the RBI or Government
- charges in the economy, society and other environmental factors
- technological changes in banks

2. Estimation of over all manpower requirements
3. Estimation of Current manpower
4. Forecast the changes in human resource inventory due to employee turnover, transfers, promotions, demotions, etc.,
5. Find out the difference between the current inventory and future requirement.

11.2.2 RECRUITMENT AND SELECTION IN BANKS :

Recruitment is a process of searching for prospective employees and stimulating and encouraging them to apply for jobs in an organisation. Sources of recruitment are 1) internal sources and 2) external sources. Normally, the banks use both the methods. Commercial banks mostly depend on

1) Internal (to be filled by promotion) and
2) External (advertisement) sources.

Each Commercial bank used to follow its own policy regarding recruitment before the setting up of the Banking Service Recruitment Boards the Banking service Act, 1975 had sought to centralise recruitment under one commission. But, it was felt that it would be difficult for recruiting a large number of candidates. Therefore, the Act was replaced in 1978. In its place, eight banking service recruitment boards were setup to cover 20 nationalised banks with one bank in each case acting as a co-ordinating bank. The recruitment board of the state bank group has been handling the recruitment of officer's cadre of the SBI and its associates. These banking service recruitment board have been rending various functions like inviting applications, conducting selection tests, conducting interviews, selecting the candidates and allotting them to different nationalised banks based upon their requirements. Selection of candidates for the pubilc sector banks is the responsibiilty of the Recruitment Boards, where as the public sector have their own selection boards.

11.3 TRAINING IN BANKS :

Training is the most important function that directly contributes to the development of human resources Training is an integral part of the HRD activity of a bank.

Objectives of Training : They are

1) To prepare the employees, both new and old, to meet the present as well as the changing requirements of the job and the bank.
2) To impart to new entrusts the basic knowledge about the organisation.
3) To assist employees to function more effectively in their present positions by providing hem latest concepts, information and techniques.
4) To broaden the minds of managers by providing them with opportunities for an inter change of experience within and out side the industry.
5) To develop the potential of people for the higher level job.
6) To ensure smooth and efficient working of a bank
7) To promote individual and collective morale a sence of responsibility and good relations and
8) to impart customer education

The bank and the individual should develop and progress simultaneously for their survival and attainment of mutual goals. Every bank, big or small, commercial or co-operative or regional small bank or development bank, old or new should provide training to all employees, irrespective of their qualifications, resultes and suitability for the jobs. Training is also necessary when the existing employee is promoted to a higher level in the bankk or transfer to a new job or occupation. Training is also necessary to equip existing employees / old employees with the advanced techniques or technology.

Training is to be provided to an employee in the following areas : 1) Bank Policies and procedures 2) particular job results 3) Human Relations 4) Problem solving and 5) Managerial and supervisory skills.

1. BANK POLICIES AND PROCEDURES :

This area of training is to be provided with a view to acquaint the new employee with the bank rules, practices, procedures, traditions, environment and services that are rendered by the bank.

2. TRAINING IN PARTICULAR JOB SKILLS :

This area of training is to enable the employee to become more effective on the job. The employee is trained regarding various skills necessary to carry out the actual job.

3. HUMAN RELATIONS TRAINING :

Bank employees are to be trained in the areas of self-learning, inter-personal competence and relations, treating the people as human beings rathar than machines. This type of training enables the employees to achieve better team work, which leads to improved eficiency and productivity of the bank.

4. PROBLEM SOLVING :

Problems exist in all banks and at all levels and most of the bank problems are common to the officers / managers engaged in the same activity at different levels of the bank. Hence, bank

management has to provide a platform and incite all the margenial perosnnel to discuss their common problems and exchange their ideas and information.

5. MANAGERIAL AND SUPERVISORY TRAINING :

Management has to train their employees in managerial and supervisory skills like planning, decision-making, organising, maintaining interpersonal relations, directing and controlling.

Banks have been providing training and development facilities to their respective bak employees through their staff training colleges and training centres. Staff college programmes for senior execuitves of Scale - IV in the area of personnel management and industrial Relations, credit management and computer awareness, Management Development programmes at Regional Managers Level. Staff colleges have also been conducting various management development programmes for RRBs sponsored by the commercial banks. The colleges have also initiated programmes on Teaching Methodology for the trainees of the training centres and training colleges. Computer centres have been established at the staff college and intensive programmes for computer application are initiated for the officers and executives of the bank. Supervisory Development programmes were designed and necessary skills are built in the faculty at the training centres to conduct these programmes for promotees and directly recruited fresh candidates.

11.4 WELFARE IN BANKS :

Labour welfare is a comprehensive term and refers to the physical, mental, moral and emotional well-being of an individual. It means taking care of the well-being of workers by employers, trade unions and governmental and non-governmental agencies.

Employee / staff welfare programmes create a sence of belonging and adequacy that benefits the organisation in the long-run. HRD for workers would mean continuous improvement of their standard of living, providing social security and a dignified role in the organisation. Some of the important welfare schemes in Banks are

1) Reimbursement of Educational expenses
2) Reimbursement of Hospitalisation expenses
3) Reimbursement towards medical check-up
4) Reimbusement of expenses incurred by executives towards mediclaim.
5) Financial assistance to employees who are on loss of pay on account of hospitalisation.
6) Incentives for promotion of small family norms
7) Relief to physically handicapped employees for purchae of curtness and other accessories.
8) Dispensary expenses
9) Provision for staff quarters

10) Provisions of recreational centres and sports activities.

11) Provisions of Holiday Homes, Rest Rooms.

11.5 INDUSTRIAL RELATIONS IN BANKS :

The concept of industrial relation means the relationship between employees and management in day-to-day working of industry. According to Dale Yoder “Industrial relation is a whole field of relationship that exists because of the necessary collaboration of men and women in the employment process of an industry. According to International labour organisation (ILO) “Industrial relation deal with either the relationship between the state and employers and workers organisations or the relation between the occupational organisations themselves”. The concept of industrial relation has been extended to denote the relation of the state with employees, workers and their organisations. The primary objective of industrial relation is to maintain harmonious relations between employees and employer.

SIGNIFICANCE :

Industrial relations are necessary

- to help in the economic progress of a country
- to help in estabilishing and maintaining true industrial democracy for the establishmetn of socialist society.
- to help management both in the formulation of informed labour relation policies and in their translation into action.
- to help government in making laws
- to encourage collective bargaining as a means of self regulation
- to regulate the production by minimising industrial conflicts
- to encourage and develop trade unions in order to improve the worker’s strength
- to avoid industrial conflict and their consequences and
- to promote and develop congenial labour-management relations.

UNIONISM IN BANKS :

Commercial banks are service-oriented banks where the quantity, quality, type of service, delivery time, all these depend on the sound industrial relations. The branches of banks are spread not only through out the length and breadth of the country but also in other countries personnel policies are formulated by banks in detail and are well publicised regarding condition of work, salary, allowances, leave work hours of rules, nature of work etc. Above all the Government, the Reserve Bank of India and the Indian Bank’s Association, trade union regulate the management of people directly and indirectly. In view of this, maintenance of congenial industrial relation is a ccrucial task in commercial banks. The increase in industrial labour has led to the formation and development of trade union.

Trade unions in the banking industry at different levels are formed into industrial unions of the banking industry. The unions of the banking industry are affiliated to the All India Bank Employees Association (AIBEA) which was started in 1946 as the first national level federation of bank employees.

It was the sole representative until the formation of the All India Bank Employees Federation (AIBEF) in 1958 and the formation of the National Organisation of Bank Workers (NOBW) in 1965. Trade union in some banks like the State Bank of India, Bank of Baroda are not affiliated to the All India Bank organisations. They have developed their own federation like All India State Bank of India staff federation various national associations formed confederation after the nationalisation of commercial banks. They are National Union of Bank Empoyees (NUBE) and National Bank Employees Congress (NBEC) officers and supervisors have their own association life officer's association and supervisors associations.

The significant and distinguishing feature of the trade union structure in the banking industry is all the federation and confederation in the banking industry without having relations with the All India Confederation like INTUC and AITUC.

UNITED FORUM OF BANK UNIONS (UFBU) :

On 14 february 1997, United Form of Bank Unions (UFBC) comprising of all the mini unions in the Banking industry, namely AIBEA, AIBOC, NCBE, AIBOA, BEFI, INBEF, INBOC, NOBW, NOBO, came into existence.

The UFBU is an umberella organisation of bank employees / officers representing the entire workforce in the Banking industry. Keeping aside all their ideoligical and organisational differences, the unions have come together and effectively countering the moves of the government and bankers combine, mataining greater unity and united action.

VIII BIPARTITE WAGE REVISION :

VI Bipartite settlement expired on 31st October. 1997, and AIBEA in its general council meeting held at New Delhi in May 1997 formulated the demands for VII Bipartite settlement and submitted the demands to Indian Bank's Association in Nov. 1997, along with other constitutents of UFBU. The negotiations Indian Bank's Association started is May 1998 and after protracted negotiation MOU was signed with IBA in March 1999 and the final negotiation were held on 22nd March, 2000 and a fulll fledged settlement was signed on 27th March 2000.

11.6 CONCLUSION :

The banking sector has been an instrument for the economic development of any nation. Today, the banking industry is facing problems of competition and technology. It has become ineventable for banks to place a higher degree of importance to train and develop the skills of their employees in congurence to the technological changes and to retain customers.

11.7 SELF - ASSESSMENT EXERCISES :

1. What is Manpower planning ? Explain the steps in manpower planning ?
2. What is Recruitment ? Explain the Recruitment practices of Indian Banks ?
3. Defineed Training. What are the objectives of Training ?
4. What is welfare ? Explain Welfare schemes?
5. Define Industrial Relations? Explain the importance of industrial relations in banks ?

11.8 FURTHER READINGS :

1. Udai Pareek, T.V. Rao, Designing and Managing Human Resource Systems, Oxford & IBH, Delhi (1982)
2. Rao, Verma, Khandelwal, Abraham, 'Alternatives Approaches and Strategies of Human Resource Development, Rawat Publication (2002).

UNIT - 12

FRAUDS AND MALPRACTICES IN BANKS

Objective :

After going through this lesson you should be able to understand about Frauds and Malpractices in Banks and the precautionery measures to be taken to prevent them as far as possible.

STRUCTURE :

12.1 Meaning of Fraud and Malpractice
12.2 Causes for Frauds in Banks
12.3 Frauds in Loans and Advances
12.4 Frauds in Routine Bank Business
12.5 Frauds in Foreign Exchange Business
12.6 Frauds in Draft's Accounts
12.7 Payment of Drafts and precautions
12.8 Computer Frauds
12.9 Internet Frauds
12.10 Money Laundering
12.11 Mitra Committee - Recommendations
12.12 Ghosh Committeen - Recommendations
12.13 Preventation of Frauds and Malpractices
12.14 Key words
12.15 Self - Assessment Questions

12.1 MEANING OF FRAUD AND MALPRACTICE :

Fraud means deceit, Trickery or Breach of confidence used to gain some unfair or dishonest advantage. Malpractice means any improper, negligent practice, misconduct or misuse. In law malpractice means failure of a professional person as a Banker to render proper services through reprehensible ignorance or Negligence or through criminal intent especially when loss follows. Banks used to get information about customers transactions records, financial position and information collected or accessed through records should be confidential and used only for expressed purposes or in accordance with law. There are various methods of frauds practicising by some unscrupulous persons with the active connivance of Banks sometimes and thereby causes loses to the Banks.

Fraud is an international phenomenon. It is increasing without any leaps and bounds. No weaponery is required to commit a fraud. It is figment of a fertile criminal mind which in turn is a product of socio-economic factors related to morality, religion, criminology and anthropology etc.,

Fraud means the successful practice of deception or artifice with the intention of cheating or injuring others financially. Frauds can have a civil or criminal aspects or both. In civil law, Fraud is a misrepresentation or contrivance to deceive, commonly by way of a false statement wilfully made or without honest belief in its truth or made recklessly oblivious of its authenticity and infact relied upon

by the person deceived. It may equally be made by concealment or deliberate omission to make a statement where one should have been made or by act or conduct. In criminal law, Fraud is deliberate dishonesty.

The Reserve Bank of India has defined "Fraud" for the purpose of reporting "all instances wherein Banks have been put ot loss through misrepresentation of Books of Account, Fraudulent encashment of instruments like cheques, drafts and Bills of exchange. Unauthorised handling of securities charged to the Bank, misfearance embezzlement, theft, misappropriation of Funds, conversion of property, cheating, shortages, irregularities etc".

The increasing crime rate throughout the world, with its complex patterns and dimensions, has become the greatest problem of society today. Incidence of frauds is not restricted to a particular Geographical region but is spread throughout the Banking Industry. But the incidence in Rural Areas has been the least. According to a survey, out of the thirty reported cases of Fraud, only two occurred at Rural Offices, 9 each at Semi - Urban and Urban Offices whereas 10 cases were reported from Metropolitan offices.

12.2 CAUSES FOR FRAUDS IN BANKS :

Modern Banking is fraught with tremendous risks. Banks have undergone a sea change in terms of their structure, functions and control. There has been a phenomenal rise in the number of branches, volume of business, number of employees, number of customers and multifariousness of operations. Though all these have added to the strength of the Banking Business, these are also the factors contributing to the higher incidence of Frauds in Banks. Among other external factors mention may be made of.

- Inordinately long and frustrating legal process, involving police investigations and court proceedings.
- Spread of education and information has made fraudulent persons aware of possibilities of Bank frauds.
- Impersonal Banking, where banker knows the customer only through his signature.
- Increasing population and un-employment making people more desperate.
- Government policy to provide loans to weaker sections of society offers opportunities to those wishing to get rich quickly.
- Tardy procedure of detection of Frauds in Banks involving time lag enables the culprits to escape and abscored paucity of evidence and benefit of doubt provide escape route to the culprits. More than 50% of the persons prosecuted are acquitted in trail.
- Falling moral values and quickbuck becoming new goddess of Public at large, Bank Fruads provide convenient access to it. High gains and no loss involved in a fraud encourage the incidence.

FRAUD PRONE AREAS IN CUSTOMER SERVICES OF BANKS

1. Deposits :

All the staff should strictly adhere to the laid down instructions in regard to the operations in Operative Accounts in issue of ATM Cards etc., to such customers. The Branch Manager/Manager of a Division must scrutinise such transactions diligently for early detection of such Frauds if any.

2. Computerised Pass Books :

The Central vigilence commission is of the view that inorder to avoid commissioning of Frauds, a Notice board in each computerised branch be put up clearly indicating that "Computerised Branch" marual entry should be authenficated by an Officer/Branch Manager". The Notice board should be displayed in Regional/Official Language.

3. Frauds In Collections :

Precautions to be taken while making payment of SC sent for collection, particularly the necessity for fixing and verifying check signed on the relative Telegraphic payment advices/the transfer responding advices for SCs sent for collection for Rs. 50,000 and above.

12.3 FRAUDS IN LOANS AND ADVANCES :

A study conducted by RBI revealed that over 80% of the Frauds in Banks took place in advances. Efficient presanction appraisal by competent persons and constant post sanction follow up is the Hall mark of good monitoring system. This also ensures high recovery percentage of Bank dues. There is a need for toning up quality of monitoring particularly scrutiny of stock inventory statements. This single step would take care of instances of pledge/Hypothecation of spurious goods financing inflated value of goods, double financing or financing against unpaid stocks, fraudulent removal of goods and pledge/Hypothecation of goods belonging to third party. 'Kite flying' or accommodation Bills, tenders of forged MTRs/RRs bad and doubtful debts, locking of Bank funds in preshipment and post shipment Finance by big borrowers are also to be checked while lending Bank Funds.

12.4 FRAUDS IN ROUTINE BANK BUSINESS :

Most of the Frauds in Deposit Accounts have been committed by making wrongful payments of which a major portion relates to payment of cheques/with drawals with forged signatures of depositors. A little extra care in verification of signatures can reduce this proportion to a large extent. RBI study also observed that the laiddown systems and procedures are not followed by the staff while opening Accounts. A vigilant approach along with meticulous compliance with systems and procedures while opening Accounts is one major step towards safety from Frauds. Proper identification of both account holder and of introducer by suitable authentic means while making payment of drafts/cheques or disbursing Loans will arrest trend of growing Frauds and shall minimize the instances of fictious accounts, Fake Account holders/Firms, Frauds in remittances and Transfer of funds, inter Branch entries in Inter Bank/Branch clearing Instruments, lockers and safe deposit vault cases, Foreign Exchange transactions and cash shortages. It has to be ensured through effective supervision that balances are tallied strickly in time, reconciliation is done up to date,

control returns are sent in time, un authorised access to confidential documents and security forms/ instruments is prevented, regular job rotation of employees is done and suspicious activities of those dubious integrity are checked/monitored. This is possible if the main charge of affairs whether at Branch level or at Control Officer Level is competent, efficient and having integrity above board, because a lot in this regard percolates top down as goes saying "Tree always starts rotting at the Top".

34th Report of the estimates committee of the Ministry of Finance (D.E.A) Recommendation

a) That the advance portfolio is highly Fraud prove area. Frauds in this area could be possible in active connivance with concerned officials. So preventive action should be taken immediately after the Fraud comes to light or as soon as the Recovery becomes irregular.
b) As soon as the advance becomes irregular the matter should be taken up immediately. No laxity in the matter should be allowed.
c) The securities charged to the Bank should be properly scrutinised, evaluated and verified from time to time.
d) BMs/Manager of Division should satisfy themselves that a borrower does not get multiple finance for the same security.
e) Insurance cover should be renewed well in time.
f) In the case of un authorised removal of Hypothecated goods, the officials have to be vigilant and submission of stock statements should be instructed to report the matter to their controlling authorities about any un-authorised activity found during the Branch Inspection.
g) If the concerned official (s) fail to report the matter they should be held responsible for any loss to the Branch/Bank.
h) The Branch Manager/Manager (s) of Division should more fast and get all records under his control (in order to maximize the chances of tempering with or destroying the records).

12.5 FRAUDS IN FOREIGN EXCHANGE BUSINESS :

RBI has listed a few deficiencies detailed vide CIRCO/CPPC/ ET/eL/OT 1999 - 2000 observed by them in Banks appraisal and exercise due diligence in supervising and maintaining of borrowal Accounts of Firms/companies involved in defrauding Banks.

FRAUDULENT REMITTANCES :

The operating staff should exercise utmost caution while dealing with FAX message from crime prove countries like Nigeria and other African countries. As per the observations countries are placed in the List are to be reviewed from time to time due to changing risk perceptions.

12.6 FRAUDS IN DRAFTS ACCOUNTS : ISSUE OF DRAFTS :

a) Except in the case of Drafts written by pin point Type writers the amount in words in the Body of the Draft should be written by blocking the space between the two words thus "Rupees Twelve/Thousand/Four Hundred/Sixty/Eight/only".

b) All Forms should be branded with the name and Code number of Branch before issue unless they are already printed there on.

In all Drafts the Box on the top right side should be filled in with the Code number of the Drawee Branch.

A hole should be punched in the Numerical Box (Corresponding to the First Digit in the Rupee amount) printed on the right hand side margin.

Reserve carbon must be used while issuing Drafts up to TL series where advices are not sent so that impression on the reserve on the D.D should appear and alteration in amount if any could be traceable immediately while making payment.

In case of Computerised Branches issuance of Drafts in the continuous stationery has since been introduced : the guidelines for issuance of Drafts on continuous Drafts Forms should be followed.

12.7 PAYMENT OF DRAFTS :

* Verify the signature of drawing officials as per Bank Records.
* Draft should not be from the lost Drafts security form series.
* The amount in words and Figures should tally
* Code No and name of issuing branch is given thereon.
* Code No, and name of paying branch should clearly mentioned.
* No alteration/addition should be left unauthorised Alteration/addition should be authenticated under full signature of the authorised signatory.
* The Instrument should be prima - facie in order.

Precautions

* The branches should ensure that the Draft Forms are branded with branch stamp before releasing the forms for use at the counters.
* Cages should be punched A sign 'x' should not be put with pen over the cage (Before delievering the Product/Draft to the purchasers).
* Amount in words and Figures should be tallied.
* Punching of the proper cage should be ensured by comparing the amount with the cage punched.
* The Ultra-Violent Lamp should be used.
* The difference in ink used should be noticed by the operating staff/passing officials at the time of paying them.

12.8 COMPUTER FRAUDS :

The vastness and complexity of all operations undertaken by computers are difficult to imagine. Computers have also created opportunities for crime that never existed. The essence of computer

Fraud lies in unauthorised access and abuse of Bank Computer System for alienating Bank's Funds. Study reveals that most of these Frauds result from laxity in security controls of the Bank's Computer System. The most common leakages in Financial Computer Systems are from within the Financial organisation, because people from within know more about the Nature of transactions and Computer Systems and about security checks. At present Indian Banks are giving priority, to computerisation and it is not reached to cent percent. But in Japan, U.S.A and other European countries entire operations were computerized.

It is not the Computer that cheats, it is the computer operator who does. A few added instructions can play haroc with the balances lying in customers Accounts or Bank's own Funds. The biggest problem for Bankers running Electronic Networks is not computer error but human criminality. Systems have to be devised to ensure the receipient of a Funds Transfer message and that the initiator is authorised to send message and that it has not been altered in transmission. This means special encryption, Cypher. coding/decoding and authentication devices built into Network terminals which is feasible in Inter Bank messages and Funds transfer as there are relatively few participants and these operate in a relatively secure environment. It is in retail Banking that security becomes a major problem and also a costly issue. ATMs are relatively secure in comparision to other system. Problems over security have led British Banks to plan for an online system which ensure process of verification.

Computer crime is advancing just as the Technology of data security. It is imperative that all Financial Institutions develop specialized skills to address every aspect of Data security. Software supplier should be independent of the equipment supplier. A very small number of extremely knowledgeable people either disgruntled employees or former employees having highly detailed knowledge about multiple level scrutinity techniques and thus being in a position to gain access can cause diversion of Funds.

12.9 INTERNET FRAUDS :

The use of deception and false claims to obtain profit is ofcourse not unique to the Internet. However, the Nature of online dynamics has introduced several factors that impact on prevention efforts. The first general factor relates to the Technical Nature of Net worked communication. The average person is not in a position to understand exactly how information is displayed, transfered or stored and this lack of knowledge provides opportunities for novel deceptions. Included within the category is the use of E-mail or websites to impersonate individuals or corporations. This activity is known as “SPOOFING” is often used to extract sensitive information by leading a user to believe that a request is coming from a reputable source such as an ISP or Credit card company. Other common swindles have involved the use of programs that secretely dial long Distance Locations for the purpose of sharing in the resulting fees paid by the un-knowing user or the use of False Login Pages that record Account Information.

Second Factor involves the Psychology of Digital environments. Messages originating from the online world are likely to be viewed by some as having an air of Authority solely due to their association with the Digital revolution. The problem of customer Fraud is being addressed on

several dimensions Central Bureau of Investigation (C.B.I) has opened a special cell to deal with Economic offences and endeavouring to track and prosecute fradulent conduct. Likewise many State Agencies have begun to prosecute criminal activity within their Jurisdiction. The range of sanctions available includes stipulated Life Time bans in the conduct of Internet Commerce, Civil Judgements, Forfeiture of property and referrals for criminal prosecution.

12.10 MONEY LAUNDERING :

Money Laudering can be described as the process of transfering illegitimate money into legitimate money. Money Laundering is called what it is because that perfectly describes what takes place illegal or dirty money is put through a cycle of transactions or washed so that it comes out at the other end as legal or clean money. In otherwords the source of illegally obtained funds obscured through a succession of transfers and deals in order that those same Funds can eventually be made to reappear as legitimate income. It is stated that the amount laundered through Western financial markets is estimated to be anywhere between U.S. $ 750 Billion to a Trillion Dollars large enough to dwarf the G.D.P of many nations and destroy their Economies.

COMMON FACTORS :

There are four factors common to all money laundering operations. To begin with the true ownership and the real source of the money is concealed. Next, the Form it takes is changed. The Launderers change the form of the proceeds in order to shrink the huge volume of cash generated by the initial unlawful activity. Thirdly, the trail left by the process is obscured so as to make it difficult to follow the money from beginning to end. And finally constant control is maintained over the money.

The money laundering process can be divided into three stazes. The placement staze is the first introduction of dirty money into legitimate world. It is done, at the simplest level by placing the illicit funds to purchase goods and services for the criminal. More sophisticated placement involves using the Banking and Financial system but this will involve disguise of true depositor. The next is the layering or agitation staze the object of this staze is to prevent the tracing of illegal proceeds by disrupting any paper trail that may have been started at the placement staze. Some methods used are under and over-invoicing and investments by off shore companies and trusts in the International markets.

The last stage of making the Dirty money is generally referred to as integration and this occurs when placement and layering have been successfully achieved. It is the means by which the criminal enjoys the proceeds of his crimes. To do this the integration process achieves the appearance of total legitimacy for the funds, there by ensuring safety from enquiry as to their true source. At the end of this staze, the money will appear to have been acquired utterly lawfully. The facilitators of money laundering are often Lawyers, Accountants, Financial Advisors and Bankers.

As already stated there is no method of laundering money. The British Banker's Association has made an attempt to list out the most basic ways by which money may be laundered. Some of the basic kinds of suspicious transactions are :

* Frequent exchange of cash into other currencies
* Customers transfering large sums of money to or from overseas locations with instructions for payment in cash.
* Large cash withdrawals from previously dormant or inactive account or from an Account which has just received an unexpected large credit from abroad
* Use of Letters of credit and other methods of trade finance to move money between countries where such trade is not consistent with the usual Business of the customer.
* Building up of large balances not consistent with the known turnover of the business of the customer and subsequent transfer to accounts held overseas.
* Frequent paying in of travellers cheques or Foreign currency drafts particularly if originating from overseas.
* Any apparently unnecessary use of an intermediary in the transaction.
* Customers who deposit cash by means of numerous credit slips so that the total of each deposit is unremarkable but the total of all the credits is significant.
* Customers who seek to exchange large quantity of low denomination notes for those of higher denomination.
* Customers who appear to have accounts with several Banks within the same locality.
* Large number of individuals making payments into the same account without an adequate explanation.

In order to arrest money laundering where Banks are mostly used in the process, it is imperative that Banks should know its customers, more particularly those dealing with Foreign Exchange Banks should make resonable efforts to determine the customers true identity and have effective procedure for verifying the bonafides of new customers.

The Prevention of Money Laundering Bill 1999 introduced in Parliament has the following provisions.

The Bill aims at prevention and punishment of offences relating to money laundering and connected activities. Confiscation of proceeds of crime disclosure of such transactions by Financial Institutions, setting up agencies and machanisms for co-ordinating measures necessary for controlling money laundering and the like.

Offence of Money Laundering has been defined in an exhaustive manner in the Bill. Whoever acquires, owns, possesses or transfers any proceeds of crime or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or canceals or aids in the concealment of the proceeds of crime will be treated as committing the offence of money laundering. Strict punishment for offence of money laundering has been proposed viz., rigorous imprisonment for a period of not less that 3 years and not more than 7 years and fine up to Rs. 5 lakhs. In certain cases even higher rigorous punishment has been proposed.

The Bill has made it obligatory for Banking companies, Financial Institutions and Intermediaries

to maintain a record of all transactions, the Nature and value of which may be prescribed whether such transactions comprise of a single transactions or a series of transactions integrally connected to each other and where such series of transactions take place within a month. These Institutions are required to furnish information of transactions referred above to an Agency within such time as may be prescribed. It will be obligatory on the part of Banks/FIS/Intermediaries to verify and maintain the records of the identify of all its clients. It is also stated in the Bill that the above said records shall be maintained for a period of Five years from the date of cessation of the transactions between the clients and the Banking company.

12.11 MITRA COMMITTEE : (ON LEGAL ASPECTS OF BANK FRAUDS) (REPORT SUBMITTED IN 2001)

BACK GROUND :

The Board for Financial Supervision (BFS) of the Reserve Bank of India constituted a committee on legal aspects of Bank Frauds in August - 2000 under the Chairmanship of Dr. N.L. Mitra, Vice-Chancellor, National Law University, Jodhpur (Rajastan).

THE TERMS OF REFERENCE :

* To define financial fraud and lay down procedural law to deal with Financial Fraud including the need for a special enactment in this regard.
* To examine the process of investigation of Bank Frauds and prosecution of persons involved therein and suggest measures for improvement.
* To examine and suggest measures to operationalise the recommendations of the Narasimham and Andhya committees ralating to legal aspects of Bank Frauds.
* To examine the need for special provisions for frauds perpetrated by staff of Public Sector Banks and
* To examine the role of RBI with regard to Frauds reported by Banks.

Recommendations :

Development of Best Practical Code. Each Bank and Financial Institution and intermediary must within the Time Frame indicated by the Regulator, prepare a Best Practice Code (BPC) for its officers and staff to provide detailed rule based procedural system in customer related matters and application of Judging power.

System of Internalization of BPC : There has to be adequate in house training - retraining system for internalizing the BPC and all directives of the Investigation and the Regulator.

Internal Check and Internal Control : There must be a system of Internal Check and Internal Control in the System Management and Reporting.

Legal Compliance Certificate : A Legal Compliance Certificate needs to be mandated in all transactions exceeding a value limit. In case of exercise of Judgement Power (Discriminatory Power) an explanation should be needed about the circumstances requiring the exercise of

discretionary power and the manner in which the same is exercised with a comment as to whether all due diligence care been taken or not.

Legal Compliance Audit : Every Institution should legal compliance and due diligence audit every year and submission of the report to the regulator and to the shareholders.

Data building on the Exercise of Discretionary Power and Monitoring the same :

Discretionary power is the Judgemental power that is exercised in the circumstances only when it is essentially needed and there is no other method left. It is not wild in fact - Divorced Speculative Power or an arbitray power. As such, every Institution should build up data of its management and staff exercising discretionary power recording all the reasons for such exercise and the consequence. A very close monitoring shall reveal how people use the power and with what result.

Appropriate Incentive System :

Use of discretionary Power must be result oriented either positively or negatively. Incentive and promotion system in an organization may have some correlation with the data of exercise of Judgemental Power and the rationality and appropriateness of such decision.

Liability of The Accounting And Auditing Profession :

If an Accounting Professional whether in course of Internal or External Audit find anything susceptible to be Fraud or Fraudulent activity or use of excess power or smell any foul in any transaction, he should refer the matter to the Regulator. Any failure should be considered as professional incompetence and be made liable.

System of Credit Registration And Data Information Sharing :

Legal support to quality improvement of credit system priority determination and enforcement is poor. The record of Registration of the credit data would in itself improve the quality of information and reduce the chances of Financial Fraud. Such Information sharing system among the constituent Institutions shall also simply the evidential process and enforcement.

Responsibility of RBI in Frauds reported by Banks :

The committee felt that the present system for monitoring Fraud and its investigation is burdened by too many layers imposing large regulationery costs on the Banks. The response of the RBI to frauds of different values in different Banks should take into Account the whole picture. Further more, individual monitoring of frauds could be left to the Banks themselves. A review of such monitoring could be made at the time of the periodical inspections of Banks.

The committee is of the view that the reporting system for frauds needs to be rationalised so that there is no duplication of efforts and that the reporting is done only in respect of information necessary for the RBI in exercising its regulatory/supervisory responsibilities. RBI has accepted many of the recommendations of Dr. L.N. Mitra Committee for implementation.

12.12 GHOSH COMMITTEE

(On Bank Frauds)

Some of the important recommendations of the committee are as under.

* Concurrent Audit by external auditors made mandatory for large branches.
* Apart from internal audit once in 12 months short surprise inspections should be made.
* A system of Revenue audit to plug the loop holes in income.
* Banks should ask the officials/employees to disclose information regarding other accounts opened in other branches.
* Photographs in accounts made mardatory.
* To keep a close watch on heavy withdrawals receipts in newly opened accounts for the first 3 months and there after too.
* Bankers receipts not to be outstanding for more than 15 days. Bankers receipts should be redeemed only with security. Otherwise it is implied that the same is dishonoured.

Volnerable Areas :

* Un-reconciled clearing transactions and entries in inter office accounts.
* Sundry/suspense accounts entries of Rs. 50,000/- and above outstanding for more than six months.

Preventive Measures :

* Detailed examination of existing organizational setup, inorder to culminate or minimise factors which provide opportunities for corruption/malpractices.
* Planning and enforcement of regular inspections and surprise visits.
* Location of sensitive spots and Regular and surprise inspection thereof.
* Proper scrutiny of personnel posted in sensitive spots.
* Maintaining proper surveillance on officers of doubtful integrity.
* Ensuring prompt observance of Conduct Rules relating to integrity such as
  - Critical scrutiny of assets and liability statements.
  - Receipt of gifts
  - Relatives employed in private firms or doing private business.
  - Benami Transactions.
* Quick disposal of disciplinary cases.
* Banks should look into the system of appraisal sanction, supervision and followup to credit and evolve clear cut systems which would enable fixing of responsibility quickly.
* A Senior/Top Management Committee should scrutinise the approved proposals for acquisition of premises, award of contracts printing of stationary.

12.13 PREVENTION OF FRAUDS AND MALPRACTICES :

Systems/Procedures Deperature :

Most Frauds arise from Neglect of Elementary Procedures. Imposter rarely has to beat out intellectual capcity. He succeeds where commonsense fails. It is observed that supervisory and control functions at branches are not being performed the way they are intended to be, but in a routine and causual manner exposing the Bank to attacks from outside the frauds highlight the failure at the Supervisor's level. Any Deperature from the laid down systems/procedures is to be viewed seriously.

Officers Responsibility :

Efficient running of the Branch and the safe conduct of daily transactions are not the responsibility of the Branch Manager alone but that of the entire management and supervisory team at the Branch. To be effective a Supervisory official should not only know what he is expected to do but also oversee the happenings in his Desk/Department/Division/Branch, so that he could immediately spot an error/wrong doing and check it in time.

FRAUDS PREVENTION :

Voucher cancellation : Frauds at Branches can be prevented by carrying out a comprehensive and intelligent check on each days transactions.

Loss Lists : The lists of tokens/bank forms/stopped cheques should be made available to all members of the staff entrusted with the handling of public transactions.

Security Forms : Care should be exercised in the handling of Security Forms like Cheque Books/ Draft Forms/Foreign M.T advices etc.,

F.I.R : In the case of loss of any Bank's Security Forms, complaint should be got registered with the necessary Police Station.

All vouchers passed for cash payment should be sent to the Cash Department after recording them in the Standard Transit Voucher Book. Paid vouchers should be returned by the cashiers to the concerned passing official through the T.V Book. Any Instrument coming directly to the Cash Department should not be paid by the cashier.

Sequence :

Before initialling the paying cashier should see that the sequences of numbers in Transit Voucher Book is unbroken and authentificated.

Paid Vouchers :

The paying cashier must return the paid Instruments to the concerned official only through Transit Voucher Book.

Entrance :

After closing hours, the Entrance to the Bank Hall should be closed. The Guard on duty should be asked to be alert at all times.

Cash Department :

This should be properly safe guarded. Independent cubicles be provided to all cashiers with prescribed looking arrangements. The Prescribed notice should also be displayed inside each cash counter.

Locking :

Cashiers seated in enclosures should be locked inside.

Cash Cabins :

Cashiers must invariably lock their enclosures/cubicles when they are at their desk. They should lock the drawers containing cash paid instruments when they leave their seats.

Tokens :

Each clerk dealing with Instruments payable in cash must be allotted a set of tokens bearing a different series of numbers from those used by other counter clerks. Their safety must be ensured at all fimes. Tokens should be checked once a month by the Head clerk or Supervising official. Proper record of missing tokens should be maintained, efforts should be made for their recovery.

In Current Accounts and CC Accounts :

The passing official should refer to the Ledger before passing debit for an amount of Rs. 10,000/- for each cash payment or over 15,000/- for Transfer payment and in all cases when he is doubtful of the constituents position. He should evidence their reference by initiating the relative entry.

Scrutiny :

The passing official must verify at the end of each day the paid instruments passed by them.

Cash Balance :

The Cash Officer must agree the total cash paid on date with the passing officials scrolls.

Main Cash Scroll :

This must be withdrawn and closed by the Accountant at the end of the day before the day transactions can be said to have agreed.

Passing Powers :

A list of limits upto which each official at the Branch may pass the cheques etc., for cash payment must be supplied to each Cash Officer, paying cash and Ledger Keeper with an authenticated specimen signature with initials.

Strangers/Outsiders :

Staff members should exercise caution to remain vigilant and exercise due care whenever strangers and outsiders (Book Binders, Tea-boys etc.,) more about in the Branch premises. Effective arrangements should be made to prevent entry of strangers/intruders in Cash Dept.

UN USED CHEQUES :

Partly used Cheque Books etc., when surrendered by the customers must be destroyed by the concerned Desk Officer, who should enter the numbers of each cheque leaves in the Ledger account concerned against his initials.

MIS APPROPRIATION AND EMBEZZLEMENT :

Branches should display on the notice board for the information of Public/Bank customers to deal with any Banking business across the counter only.

These steps can help the bankers to avoid Frauds.

12.14 KEY WORDS :

1. FRAUD	:	This means decit, Trickery or Breach of confidence used to get some unfair or dishonest advantage.
2. MALPRACTICE	:	This means any improper negligent and unfaithful practice, misconduct or misuse.
3. SPOFING	:	Using of E-mail or websites to impersonate individuals or corporations
4. T.V. BOOK	:	Transfer Voucher Book.
5. F.I.R	:	FIRST INFORMATION REPORT
6. C.C	:	CASH CREDIT
7. F.I.'s	:	FINANCIAL INSTITUTIONS

12.15 SELF - ASSESSMENT QUESTIONS :

1. Define a Fraud and Malpractice ?
2. What is Money Laundering ? Explain the stazes of the process of Laundering.
3. How can Banks prevent Money Laundering?
4. Discuss the Mitra Committee Recommendations on Bank Frauds.
5. Discuss the Gltosh Committee Recommendations on Bank Frauds.
6. Discuss Fraud prove areas in customer services of Banks.
7. Briefly write on Internet Frauds.
8. Explain the ways to prevent Frauds and Malpractices in Banks.

Lesson - 13

CUSTOMER SERVICE AND SOCIAL RESPONSIBILITIES OF COMMERCIAL BANKS

Objectives :

After reading this unit, you should be able to :

- understand the responsibility of banks towards customers, society, government, financial institutions and employees.
- know the importance of customer service, recommendations of Goiporia Committee.
- know about the ombudsman scheme 1995.

STRUCTURE :

13.1 Customer service - Introduction

13.1.1 Improving customer service - Recommendations of Goiporia Committee

13.1.2 The Banking ombudsman scheme 1995

13.1.3 Customer service regarding collection of cheques & Savings Bank Accounts

Social Responsibility of Commercial Banks - Introduction

13.2 Introduction

13.2.1 Responsibility towards customers

13.2.2 Responsibility towards society

13.2.3 Responsibility towards Government

13.2.4 Responsibiilty towards other financial institutions

13.2.5 Responsibility towards employee

13.3 Conclusion

13.4 Self - Assessment exercises

13.5 Further Readings

13.1 CUSTOMER SERVICE IN COMMERCIAL BANKS :

INTRODUCTION :

Over the last ten years, there has been a great transtion in the Indian banking industry. The radical changes in the global financial scene has had a profound impact on Indian Banking System. As a result, banks have been diversifying their activities in such areas as merehant bank, leasing, mutual funds, credit cards, Debit Cards, ATM's, Internet banking and Insurance etc. They have also introduced computers, ATMs, tele-banking etc. to improve customer satisfaction.

The customer service means generation of range of services designed to meet the customer needs not only the present but also the demand of the potential prospective customers. The customer service is gaining importance in the face of growing competition, technological advancement, expanding world market, changing international environment and increasing customer sophistication and awareness.

Commercial banks are rendering multi services to the customers and amongst those important ones are Safety custody, Safe Deposits, Covers, Credit loans, Personal Loans, Travellers Cheques, Teller System, Credit Cards, ATMs, Gift Cheques, Consultancy Services, Advances against life policy extending guarantee, collection of cheques, demand drafts, bills of exchange, promissory notes etc. Key areas of customer's services to be attended to timely and regularly are

- updating of saving bank pass books
- Punctuality of Staff
- Handling of complaints separately without much loss of time
- Submission of statements of accounts to customers
- Immediate credit for Institution cheques / and bills
- Cleanliness and upkeep of premises.

13.1.1 IMPROVING CUSTOMER SERVICE :

Today, the major implementing factor for the servival of industrial business and commercial organisation in technology. Banking being a service industry, a lot depends on efficient and prompt customer service. The RBI has advised all banks to monitor and evaluate the 25 core recommendations of the Goiporia committee as part of implementation of the recomendations on customer services in banks.

To improve customer service in banks, the Government of India appointed the "Banking commission in 1972. In 1975, a working group on customer services was appointed under chairmanship of Shri R.K. Talwar. The Talwar committee suggested 176 recommendations.

On the basis of these recommendations, an elaborate infrastructure was builtup in the banking sector for the redressal of customer grievances. Complaints cells were established. Customer service centres were also setup. Notice Boards displaying time norms in branches every where in the country. The 15th day of every month is set aside for hearing of complaints, and customers are free to meet bank officers without prior appointment, at any time between 3 pm to 5 pm.

In 1990, the Reserve Bank of India appointed a committee on customer service under the chairmanship of Shri M.N. Goiporia, Ex-chairman, State Bank ofIndia. The committee has made a number of recommendations to improve customer service in banks particularly in the areas of speed, efficiency, accurancy and attitude of the staff.

Based on the recommendations of Goiporia committee, the Reserve Bank issued detailed guidelines in 1992 to the banks relating the

1) Extension of business hours for all banking transactions except cash, upto one hour before close of the working hours.
2) Commencement of employees' working hours 15 minutes before commencement of business hours to ensure service to customers exactly at the commencement of business hours.
3) Provision of one or more Teller counters.
4) Acceptance of small denomination notes from customers and also from non-customers for issurance of drafts.

5) Exchange of multilated and soiled notes.
6) Notes / coins counting machines should be introduced whenever volume of work is large to reduce wasting time for customers at cash counters.
7) Publicity about nomination to help customers
8) For safe guarding currency notes, the notes should be punched with paper seal / band.
9) Nomination facility should be available not only for deposit accounts but also for safe custody articles and safe deposit lockers.
10) Guiding customers to make proper investment decisions in various deposit schemes.
11) Speedy communication of information of interest rate changes to customers as well as bank branches.
12) Examining the possibility of setting up of specialised branches / subsidiaries to provide locker facilities in residential areas.
13) Payment of interest on delayed collection of outstation instruments.
14) The facility of instant credit of outstation cheques should be raised to from 2,500 to Rs. 5,000/-.
15) Dishoured instruments should be returned to customers within 24 hours.
16) Training programmes should be customer oriented, to develop right trend of attitude towards customer service, and empathy towards customers needs and expectations.
17) Quality circles, think-tank groups, customer care clubs etc. should be encouraged enable employes to involve themselves in the area of service to the customer
18) At metro and urban centres, work should be automated and moderen techniques of working should be adopted.
19) Periodical meeting should be held with customers and their representatives.
20) In predominantly residential areas, banks should have sundays working, to provide banking services.
21) Time norms for specialised business transactions should be displayed prominently in the banking hall to attract the customer's attention.

13.1.2 THE BANKING OMBUDSMAN SCHEME 1995 :

The banking ombudsman scheme, 1995 was announced in June 1995, under the provisions of the Banking Regulation Act 1949 for expeditions and inexpensive resolution of customer complaints about the deficiencies in banking services. All scheduled commercial banks having business in India (except RRBs) and scheduled primary cooperative banks are covered under the scheme.

Ombudsman is a person appointed by the Reserve Bank of India to resolve complaints relating to provisions of banking services and to facilitate the satisfaction or settlement of such complaints. It is an effective alternatives for quick, impartial, expert and cost-effective method of settling disputes between the banker and the customer.

The ombudsman will attempt to bring about a settlement between the complaint and the Bank through conciliation or mediation. If the complaint is not settled by agreement or recommendations within two months from the date of receipt of the complaint, he can pass an Award.

13.1.3 CUSTOMER SERVICE REGARDING COLLECTION OF CHEQUES&SB ACCOUNTS :

Based on the recommendation of the IBA, it has been decided that the present ceiling of Rs. 7,500 should be enhanced to Rs. 15,000 for immediate credit of outstation / local cheques subject to the existing guidelines issued by the Reserve Bank. These guidelines mainly relate to extension of such facility to all individual depositor without laying any stipulation for minimum balance for the purpose, proper conduct of account of customers, charging of interest for the period the bank is out of funds in the event of cheque being refused unpaid and publicity of availability of such facilities at branches.

SAVINGS BANK ACCOUNTS :

Banks have been advised that they should inform customers, regarding the requirements of minimum balance at the time of opening the SB account and also any subsequent charges in this regard to the account holders is a transparent manner as deemed fit by them.

13.2 SOCIAL RESPONSIBILITIES OF COMMERCIAL BANKS :

INTRODUCTION :

The commercial banks in India are to perform a variety of roles such as promotion of the interest of the depositors, giving fair and adequate return on the deposits, assisting the people who are in need of financial assistance to raise their standard of living, upliftment of the downtrodden in the society, a more responsible and accountable role in Government, safeguarding the rights and interests of the employees, and apart from all those roles, the commercial banks have to earn profits to sustain their existance and to do justice to all these roles.

Responsibilities of banks are grouped as :

1) Responsibilities towards customers
2) Responsibilities towards society
3) Responsibility towards government
4) Responsibility towards other financial institutions
5) Responsibility towards employees

13.2.1. RESPONSIBILITY TOWARDS CUSTOMERS :

The whole philosophy of the social responsibility of commercial banks centered around the service to its customers. Customers of a commercial bank are those who have bank accounts in their names and such accounts are used essentially for the business of banking i.e., accepting the deposits and lending of money. Thus, the both depositers and borrowers are termed as customers of a commercial bank. Both individuals, institutions and corporate bodies may be included in the term “customers'' of a bank. Depositors are lenders of money to the community through banks. Apart from a comparatively higher rates of interest, they are also interested in the safety and liquidity of funds.

Easy approach to the bank office, courteous behaviour of bank employees, stable, efficient and quick service particularly at counters, single window systems, convenient banking hours, ATMs, and longer working hours etc., are the expectations of the customers of a bank. This leads to good image of banks which boosts the confidence of the customers.

Borrowers are the purchasers of services of these banks. They are always interested in good service and efficiently available without any cumbersome procedures. The Banks should grant credit to all those who deserve it and to those sectors. The credit should be given for approved purposes where the proposals should be technically feasible and economically variable. Customers in all types of areas should be provided with convenient banking hours suited to the needs of different places. Besides the banks / braches should be kept open for long hours for transacting banking business.

13.2.2. RESPONSIBILITY TOWARDS SOCIETY :

The nationalised banks as centres of economic activity are called upon to solve many of the problems of the society such as poverty, unequal distribution of national income, chronic employment, and underemployment of natural, economic and human resources, lop sided economic development etc., Banks have been entrusted with the task of opening branches in unbanked areas to evolve all round development of those areas. The commercial banks are supposed to see that evils like red-tapism, mis-utilisation, and mis-appropriation of funds do not creep in to the banking system which adversely effects the image of the banks. In turn, the society should also extend in full co-operation to the banking industry by providing an arricable and legitimate environment for the banks to function more smoothly and responsibly.

13.2.3. RESPONSIBILITIES TOWARDS GOVERNMENT :

A Government which is committed to social welfare always strives to enhance the social welfare. Nationalisation of commercial banks is a step in that direction. As the sole owner of these banks, the objective of the Government is not to make them unprofitable entities and philanthropic institutions but to ensure under social service by maintaining their commercial nature. This requires that these commercial banks are excepted to give reasonable return to the Government. Further the government as planning authority expects the managements of these banks to ensure the functioning of these banks is conformity with the plan strategy. The success of economic planning largely depends upon the cooperation from all sectors of the economy including the financial institutions. The Government has identified certain sectors as priority sector and timely and adequate credit should be extended to these sectors.

The commercial banks are expected to extend productive and employment oriented to consultancy services with regard to technically feasible and economically viable projects. Further the commercial banks are expected to be responsible to the RBI, which is the monetary authority in our country. RBI has been assigned both promotive and regulatory functions as a result it also gives direction to the nationalised banks from the time to time for a sound banking system with a view to servicing the best interests of the society. In this connection, all the commercial banks are expected

to implement the RBI directives in respect of bill market, several schemes like Lead Bank, Financing, Farmers Credit Cooperative Societies and Swarnajayanti Gram Swarozgar Yojana etc.,

13.2.4. RESPONSIBILITIES TOWARDS OTHER FINANCIAL INSTITUTIONS :

Nationalised commercial banks are a part of the organised financial infrastructure of the country. Apart from these banks, the financial infrastructure includes old private banks, new private banks, foreign banks, co-operative banks and regional rural banks as the constituents of the money market and LIC, IFC, SFC, & IDBI as constituesity of the capital market. These banks should act in the ethical manner, properly guide their clientele, provide consortium leadership to other institutions and agencies, inter-bank lending, resort to fair practices etc.

13.2.5. RESPONSIBILITIES TOWARDS EMPLOYEES :

As banking is a service industry, all types of services rendered by it are directly affected by the skill and attitude by employees for they are in direct contact with customers. Lack of cardial realtions between the management and the employees of an enterprise leads to discontentment and dis-satisfaction. It leads to deteoriation of profitability, efficiency and productivity of the bank, which ultimately results in poor customer service. This can be reduced by implementing pay scale revisions, paying fair and adequate remuneration, resorting to fair human resource development practices and positive motivation etc.

13.3 CONCLUSION :

Customer satisfaction is a dominant factor in the success of any business. In the service industry where intangable products are to be marketed, the importance of customer satisfaction is become more significant.

13.4 SELF-ASSESSMENT EXERCISES :

1. Explain the importance of social responsibility of Commercial Banks
2. Write a short note on ombudsman scheme
3. What is customer service ? How to improve customer service ?
4. What are the Recommendations of Goiporia Committee ?

13.5 FURTHER REFERENCES (READINGS) :

1. RBI Annual Report.

Lesson - 14

INNOVATIONS IN BANKING SERVICES

Objectives :

After reading this unit you will be able to :

- ♦ know about the reasons for innovations in Banks
- ♦ know about Credit cards and its features
- ♦ know about Debit cards, ATMs and smart cards
- ♦ know about EFT and Internet Banking
- ♦ know about Merchant Banking & Mutual funds

STRUCTURE :

14.1. Introduction
14.2. Credit cards
14.3. Debit cards
14.4. Automatic Teller Machines [ATMs]
14.5. Technology in Banking
14.6. Electronic Funds Transfer [EFT]
14.7. Internet Banking
14.8. Banks entry into Business
14.9. Insurance Business by Banks
14.10. Merchant Banking
14.10.1 Services and functions of Merchant Bank
14.11. Mutual funds
14.11.1 Regulation of Mutual funds
14.11.2 Policy development
14.12. Conclusion
14.13. Self - Assessment Exercises
14.14 Further Readings

14.1 INTRODUCTION :

In recent years, the banking industry has been undergoing repaid changes, reflecting a number of underlying developments. The most significant changes have been in communication and information technology, which have accelerated and broadened the dissemination of financial information while lowering the costs of many financial activities. These developments have manifold consequences for the institutional and systematic structure of the financial sector in general and banking in particular.

Responding to these changes, commercial banks in India, have been diversifying their activities in such areas as merchant bank, leasing, mutual funds, consumer credit, credit cards, Debit cards, housing, Finance and Insurance etc. They have also introduced computers, ATMs, Internet banking, tele- banking etc. to improve customer satisfaction.

14.2 CREDIT CARDS :

The evolution of Plastic money dates back to the 1920s, when the first payment card was introduced in the USA. Diners club and American Express launched the world's first plastic card in the USA, in 1950. The first credit card and was introduced by Diners club in 1951. However, the plastic cards began to be widely used after 1970, when the specific standards for magnetic strip were set.

The global card market is dominated two US based players. Visa and Master card. Visa introduced its first credit card, Bank Ameri card in 1958, which went on to become a great success, acquiring universal merchant acceptance. Visa's card base increased significantly and reached one billion in 2000. Master card International was established in the 1970s. The first Master card was issued in 1988, in Soviet Union. By 2000 Master card had over 30 offices around the world in various countries like India, Thailand, Chile, US, China, Europe, South Korea, Taiwan and others.

Credit cards are electronic cards that enable the card holders to pay for purchases and withdraw cash. Short-term credit is made available to the customer in the form of a credit card, by a bank or a financial form. The credit amount is determined on the basis of the customer's income, debts, credit history and the ability to pay.

Commercial banks introduced credit card facility in the early 1980's. Since then, their facility has become increasingly popular among the banks as well as the public [Exhibit - I].

FEATURES OF CREDIT CARDS :

Important features of credit card facility are given below.

1. Credit card helps the cardholders to buy when he wants and pay later, by giving them an interest free credit period of 30 to 50 days.
2. Credit cards are issued to people who are having a minimum income.
3. Interest is payable if the loan amount is not paid within the stipulated time period.
4. When a credit card is used for cash withdrawals, a charge is levied, along with an interest that is charged from the date of such withdrawal.
5. It is a convenient medium of exchange without using money.

14.3 DEBIT CARDS :

It is also known as a Check Card. It is the card that authorises EFT. When any one uses a debit card, the amount is immediately deducted from his/her savings account. The debit card allows card user to spend only what is in user's bank account. Debit cards can be used with or without identification (PIN) almost every where retail stores, petrol stations, restaurents, hotels etc. Advantages of using debit cards are -

- Obtaining a debit card is much easier than obtaining a credit card
- Using a debit card instead of writing cheques saves you from showing personal identification.
- Using a debit card frees you from carrying cash, travelling checks or a cheque book.
- Merchants accept debit cards more readily than cheques.

14.4. AUTOMATIC TELLER MACHINES [ATMs] :

An automatic teller machine or ATM allows a bank customer to conduct their banking transactions from almost every other ATM machine in the world. Don Wetzel invented the first successful and modern ATM in the USA. The first ATMs were off line machines, meaning money was not automatically withdrawn from an account.

Networking in banks is also an important activity which has been receiving focused attention. SBI has been aggressive in adding ATMs, and it entered into agreement with ICICI Bank and HDFC Bank. This tic-up would create a shared network of 4,600 ATMs.

Multi-bank alliances for ATM sharing began to emerge in 2003. Till date, there have been four such alliances. IDBI Bank, Citi Bank, Stanchart and UTI Bank have come together to set up a shared ATM net work. Punjab National Bank (PNB) has already signed up with UTI Bank, Global Trust Bank, Indian Bank and Oriental Bank of Commerce. Recently, five public sector Banks, Union Bank of India, Central Bank of India, UCo Bank, Indian Overseas Bank and Canara Bank tied up to launch “Cash on-line”. Bank of India, Syndicate Bank, United Bank India and Union Bank of India tied up to launch “Cash tree”.

SMART CARDS :

Smart Cards are basically cards using computer circuits in them would serve as multipurpose cards. Smart cards are essentially a technologically improved version of credit and debit cards and used as ATM cards.

14.5 TECHNOLOGY IN BANKING :

Large scale usage of IT by banks has resulted in computerisation of many branches and their inter-connectivity by means of safe and reliable networks. While the new private sector banks, foreign banks and a few old private sector banks have already computerised their operations, and the public sector banks are on the threshold of achieving the status of 100 percent computerisation of their business.

In recent years, the Reserve Bank has assigned priority to upgrading the technological infrastructure of the Indian Financial System. As part of restructuring of the banking sector, emphasis has been accorded to improvements in payment and settlement systems. This includes measures aimed at integration of financials entities through the INFINET (Indian Financial Network) encouraging retail electronic mode of payment including implementation of an Electronic Fund Transfer System, Real Time Gross Settlement System (RTGS), Centralised Funds Management System (CFMS), the NDS and the Structured Financial Messaging Solution (SFMS).

14.6 ELECTRONIC FUNDS TRANSFER (EFT) :

The EFT enables transfer of funds within and across cities and between branches of a bank and across banks. The Reserve Bank is in the process of implementing the National Electronic Funds Transfer (NEFT) System - a Nation-wide Electronic Funds Transfer System - to provide for transfer of funds electronically across a large number of bank branches in the country. As a first step, a Special Electronic Funds Transfer (SEFT) System was implemented with effect from April1, 2003. The system is designed to provide for same day inter-bank transfer of funds between accounts

maintained in any of the designated participating branches which are networked, so that SEFT messages could be transmitted electronically.

14.7 INTERNET BANKING :

Economic integration with in and across countries, deregulation, advances in tele communications and the growth of the Internet and wireless communication technologies are dramatically changing the structure and nature of financial services. In order to promote safety and soundness of e-banking activities, the Reserve Bank of India constituted a working group on Internet Banking to examine the different issues relating to internet banking and recommend technology, security, legal and operational standards. In its report, the working group has classified the Internet banking products into 3 types; 1) Information only Systems 2) Electronic Information Transfer System and 3) Fully Electronic Transactional Systems.

1) Information only Systems :

General purpose information like interest rates, branch locations, product features, FAQs, loan and deposit calculations - etc; are provided on the banks web site., and this information and application forms can be downloaded from the site through e-mail.

2) Electronic Information Transfer System :

These systems provide customer specific information in the form of account balances, transaction details, statement of accounts etc. Identification and authentication of the customer is through pass word. It is ‘read only’ format.

3) Fully Electronic Transactional System :

These Systems allow bi-directional transactional capabilities. Transactions can be submitted by the customers for on-line up date. These systems require high degree of security and control.

14.8 BANK’S ENTRY INTO INSURANCE :

The Government of India notification specifying insurance as a permission form of business under Section 6 (1) (0) of the Banking Regulation Act, 1949, was issued on August 3, 2000. Based on the above, detailed guidelines were issued by Reserve Bank on August 9, 2000. Since, then State Bank of India has been permitted to set up a life insurance subsidiary on risk participation basis with 74 percent equity holding, Jammu & Kashmir Bank Ltd., and Vysya Bank Ltd., have been accorded approval to contribute 25 percent and 49 percent, respectively, to the equity of insurance joint ventures on risk participation basis. Punjab National Bank and Vijaya Bank were permitted to make strategic investment to the extent of 15 percent and 8 per cent, respectively, in the life and non-life insurance joint venture and in a distribution and services company Citi Bank, American Express, Standard Chartered Bank, HSBC, ABN - Amro, HDFC Bank and Deutsche Bank have been given ‘in principle’ approval to act as corporate agents of insurance companies for distribution of insurance products on fee basis. All these approvals have been granted subject to the banks obtaining necessary clearance from Insurance Regulatory and Development Authority (IRDA).

14.9 INSURANCE BUSINESS BY BANKS :

Banks which satisfy certain parameters i.e., minimum networth of not less than Rs. 500 crore, CRAR not less than 10 percent, net profit for the last three continuous years, reasonable level

of non-performing assets and a satisfactory track record of the performance of their subsidiaries, if any, are eligible to set up insurance joint venture on risk participation basis.

Banks which are not eligible as joint venture participants, as above, would be allowed to take up strategic investment upto a certain limit for providing infrastructure and services support, if these banks satisfy some of the criteria specified there in. Further, any SCB or its subsidiary would be permitted to undertake insurance business as agent of an insurance company and distribute insurance products without any risk participation.

During 2002-2003 under review, 17 public sector banks, nine private sector banks and one foreign bank and a subsidiary of a private sector bank were given “in principle” approval for acting as corporate agents of insurance companies to undertake distribution of insurance products on non-risk participation basis. For entering into a referral arrangement with insurance companies subject to prescribed conditions, five public sector banks, two private sector banks and one foreign bank were given approval during 2002-2003.

14.10 MERCHANT BANKING :

The term “Merchant Banking” came from the early years of banking when only merchants required the facilities of finance. A ‘Merchant Banker’ means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as Manager, Consultant, Advisor of rendering corporate Advisory services is relation to such Issue Management.

The Banking Commission in its Report in 1972 has indicated the necessity of merchant banking services in view of the wide industrial base of the Indian economy. The Commission was in favour of a district institutions [which is different from Commercial banks and term lending institutions] to render merchant banking services. The commission suggested that they should offer investment management and advisory services particularly to the medium and small savers.

Merchant Banking in India was started in 1967, when Grindlays Bank established a division followed by City Bank in 1970 and the State Bank of India in 1972. The Commercial Banks that followed SBI in setting up merchant banking centres were Central Bank of India, Bank of India and Syndicate Bank in 1977, Bank of Baroda, Standard Chartered Bank and Mercantile Bank in 1978; and United Bank of India, United Commercial Bank, Punjab National Bank, Canara Bank and Indian Overseas Bank in early 1980s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI in 1986 and IDBI in 1991.

Merchant Banking activities are regulated by 1) guidelines of SEBI and Ministry of Finance 2) Companies Act, 1956 and 3) Listing guidelines of Stock Exchanges and 4) Securities Contacts (Regulation) Act, 1956.

14.10.1 SERVICES AND FUNCTIONS OF MERCHANT BANK :

They are -

* organising and extending finance for investment in projects
* assistance in financial management,
* acceptance house business,
* raising Euro-dollar loans and issue of foreign currency bonds,

* financing of local authorities,
* financing of export of capital goods, ships, hydro power installation
* financing of railways
* financing of hire - purchase transactions
* financing for equipment leasing
* financing for mergers and takeovers, valuation of assets.
* investment management and promotion of investment trusts.

14.11 MUTUAL FUNDS :

A mutual fund is a special type of investment institution which acts as an investment conduit. It pools the savings, particularly from small investors and invest in a well-diversified portpolio of sound investment. Until 1987, the UTI was the sole mutual unit trust in the country. The subsidiaries of public sector banks launched mutual funds. Later, the Life Insurance Corporation of India and General Insurance Corporation of India also floated mutual funds. In the post - 1992 period, mutual funds sponsored by other public and private sector financial institutions, corporates and foreign institutional investors. At present, nearly players in the market.

14.11.1 REGULATION OF MUTUAL FUNDS :

The mutual funds operate with in the frame work of the SEBI Regulations. The Reserve Bank of India issued a set of guidelines in 1987 for bank - sponsored funds. On 1991, the Govt of India initiated the process of creating a common regulation of all mutual funds and to permit the entry of private mutual funds. The Dave Panel submitted its recommendations regarding the regulations of mutual funds in 1991. In October 1991, the SEBI issued guidelines for the formation of Asset Management Companies [AMCs] for mutual funds. A comprehensive set of guidelines was issued by the Ministry of Finance in February 1992. In 1993, the SEBI issue comprehensive mutual funds regulations. These were replaced in 1996, which were amended in 1998.

The main elements of the SEBI regulatory mechanism of mutual funds other than UTI are

* procedure for registration with SEBI
* constitution and arrangement of mutual funds and operation of trusts
* constitution and management of asset management company and custodian
* schemes of mutual funds
* investment objectives and valuation policies
* general obligation
* inspection and audit
* procedure for action in case of default

14.11.2 POLICY DEVELOPMENTS :

During 2002-2003, various measures have been undertaken to improve the operations and governance of mutual funds. These include, inter alia, disclosure of performance of bench marks, guide lines for valuation of unlisted equity shares, distribution of realisation from non-performing or illiquid assets to old investors after redemptions, emphasis on following the code of conduct and insider trading regulations, uniformity in calculation of sale and repurchase price, increasing the frequency of meeting of trustees, guide lines on risk management norms, increase in the investment

limit in foreign securities and mandatory registration of intermediaries engaged in selling and marketing of mutral funds units.

During 200-2001, several steps were taken by SEBI to impart flexibility to the operations of Mutual Funds [MFs] and to safeguard the interests of the investors in mutual funds. Investment norms relating to mutual funds were liberalised allowing them to invest in mortgage backed securities of investment grade and above. Further, the open ended schemes were allowed to invest upto 5 percent of their net asset value in unlisted equity shares. The above two measures are expected to increase the funds to the housing sector and venture capital industry.

14.12 CONCLUSION :

Technology has a definitive role in facilitating transactions in the banking sector and the impact of technology implementation has resulted in the introduction of new products and services by various banks in India.

14.13 SELF - ASSESSMENT EXERCISES

1. What is a Credit Card? Explain the important features of Credit Cards.
2. What is a Debit Card? What are the advantages of Debit Cards?
3. What is Internet Banking? Explain.
4. What is Merchant Banking? What are the functions of Merchant Bank?
5. Briefly outline the framework of regulations of the mutual funds industry in India.

14.14 FURTHER REFERENCES (READINGS) :

1. Kalakota & Whinston "Prontiers of e-commerce", Pearson Education (2002).
2. Kalakota & Whinston " E- Commerce", Pearson Education (2000).
3. H.R. Machi Raju "Merchant Banking" Principles and Practice, New Age International Pvt. Ltd., (2003).
4. Sekhar & Sekhar, "Banking Theory & Practice", UBS Publishing (2000).

EXHIBIT I

AVAILABLE CREDIT CARDS IN INDIA

CREDIT CARD	CARD ISSUER
American Express Gold	American Express
American Express Green	
BOI India Card	Bank of India
BOI Gold	
Bob Card Gold	
Bob Card Silver	Bank of Baroda
Bob Card Exclusive	
Bob Premium	
Can Card	Canara Bank
Citi Bank Gold Card	
Citi Bank Silver Card	
Citi Bank Platinum Card	
Citi Bank Diners Club Card	
Citi Bank Visa Card for women	
Citi Bank Cry Card	Citi Bank
Citi Bank Silver International Credit Card	
Citi Bank Gold International Credit Card	
Citi Bank Times Card	
Citi Bank Electronic Credit Card	
Citi Bank Indian Oil International Credit Card	
HSBC Gold	
HSBC Classic	HSBC
ICICI Sterling Silver Credit Card	ICICI
ICICI Solid Gold Credit Card	
ICICI True Blue Credit Card	
SBI Card	SBI
ANZ - Gold	ANZ Grindlays
ANZ - Silver	
Stanchart Gold	Standard
Stanchart Executive	Chartered
Stanchart Classic	Bank

Lesson - 15

MANAGEMENT INFORMATION SYSTEM FOR BANKS

Objective :

After going through this lesson you should be able to understand what is management informatioin system, changing dynamics is the Banking Industry, Home Banking, Banking through on line services. Management issues in Online Banking. Backoffice support for online Banking. Integrating Telephone call centres with web etc.,

STRUCUTURE :

15.1 Introduction
15.2 Management Vs Information
15.3 Nationalised Banks And I.T.
15.4 Branch Automation
15.5 Changing Dynamics in the Banking Industry
15.6 Technology based financial services products
15.7 Banking Via online services
15.8 Management issues in online Banking
15.9 Components of Modern Banking MIS.
15.10 V. Sats
15.11 Vitrual Banking
15.12 Information Technology Act. 2000
15.13 Key Words
15.14 Self-Assessment Questions
15.15 Suggeted Readings

15.1. INTRODUCTION :

Information processing is a major societal activity. A significant part of an individual working and personal time is spent recording, searching for and absorbing information computers have become an essential part of organisational information proceedings and communication of information due to the power of technology. Today computerised processing of transaction data is a routine activity in organization and more particularly in Banks. The capability of automatic information processings has permitted an expansion in the scope of formalized organisational information use. Management information system (MIS) is a broad concept rather than a single system. Some MIS activities are highly integrated with routine Date Processing, while other MIS applications are used in Decision making function.

These is no consensus on the definition of the term “Management Information System” some writers prefer alternative terminology such as “Information Processing System”. “Information Decision System”. “Organisational Information system or simply Information System” to refer to the computer based information processing system which supports the open actions, management and decision

making function of a Bank. A definition of management information system as the term is generally understood is an integrated, user machine system for providing information to support operations, management, and decision making functions in an organization. The system utilises Computer Hardware and Software; Manual Procedures, Models for analysis, planning control and decision making and a data base. The fact that it is an integrated system does not mean that it is a single monolithic structure, rather it means that the parts fit into an over all design.

A Management Information System is

- An Integrated user machine system
- For Providing Information
- To support the operations, management, analysis and decision making functions in an organization. The System utilizes
    a) Computer Hardware and Software
    b) Manual Procedures
    c) Models for Analysis, Planning, Control and Decision making and
    d) A Data Base.

Conceptually, a management information system can exist without computers but it is the power of the computer which makes MIS feasible. The question is not whether computers should be used in Management Information Systems, but the extent to which information use should be computerized. The concept of a User machine system implies that some tasks are best performed by humans, while others are best done by machine. The user of an MIS is any person responsible for entering input data, instructing the system or utilizing the information out put of the system. User-machine interaction is facilitated by operations in which the user's input-output device (usually a visual display terminal) is connected to the computer. The computer can be a personal computer serving only one user or a large computer that serves a number of users through terminals connected by communication lines.

Management information system typically provide the basis for integration of Banks Information Processing. Individual applications within information systems are developed for and by diverse sets of users information systems function integration is also achieved through standards, guidelines and procedures set by the MIS function. The terms "Information" and "Data" are frequently used interchangeably. However, information is generally defined as Data that is meaningful or useful to the recipient. Data items are therefore the raw material for producing information. The underlying concept of a data base is that data needs to be managed in order to be available for processing and have appropriate quality. This Data management includes both software and bank. The software to create and manage a database is a Data Base Management System.

It is usually insufficient to human recipients to receive only raw data or even summerised data. Data usually needs to be processed and presented in such a way that the result is directed towards the decision to be made.

When the concept of MIS was first introduced, many proponents envisioned a single highly integrated system that would bring together processing for all Banking Functions. Over time the concept of a single, highly integrated system was demonstrated to be complex to implement. The

MIS concept is now that of a Federation of subsystems developed and implemented as needed but conforming to the overall plan, standards and procedures for MIS. A Data Processing System processes transactions and produces reports. It represents the automation of fundamental, routine processing to support operations. One important aspect of the difference between MIS and routine data processing is the capability to provide analysis, planning and decision making support. An MIS Orientation means Information resources are utilised so as to improve decision making and achieve improved banking effectiveness. Information resources are also used as a means of achieving a competitive advantage. A Decision support system is an information system application that assists decision making. DSS tend to be used in planning analysing alternatives and trail and error search for solutions.

15.2. MANAGEMENT VS INFORMATION :

The Paradigm is packaged MIS is that information is indispensible for effective Management. The Paradox is that, to produce information of value one needs effective Management. Information Management is in fact a discipline in its own right with as wide a sweep of general management. Skill requirements are equally diverse conceptual, quantitative and behavioural.

INFORMATION :

Credit appraisal is considered an appropriate segment for what have to be known as decision support systems. At the gross roots level, quantitative systems evaluate financial parameters with reference to standards. The decision-maker, on the other hand is looking for insights into management, technology and those intangibles that make one Bank tick when others in the same Banking, Industry fare badly.

15.3. NATIONALISED BANKS AND I.T. :

The computerisation in Banking Industry started mainly with the implementation of first Rangarajan Committee Report. The salient features of this report are (a) The machines shall be stand alone each dedicated to only one of the functions i.e., current account including overdraft account, Savings bank Account etc., (b) Average number of vouchers per machine of Current Account including over draft accounts or cash credit and loan account shall be about 400 per day (c) The number of accounts on the machines for savings bank account shall be 2200 (d) The machines shall not be installed at the Rural/Semi-Urban Branches of any Bank.

Standardization of systems and procedures among Banks so as to develop uniform software has not received due attention. On the otherhand each bank has chosen to appoint an external consultant to develop necessary software to implement in their respective bank accounts. Since Unions and Managements have arrived at an amicable settlement regarding computerisation, the task has been achieved considerably.

The Computerization at branch level should aim at improving the coustomer service. There have been complaints about deterioration of csustomer service in the Nationalised Banks in recent years. The general complaint against the branches is that they will not get any information immediately. Updations in the Pass Book are not done, standing instructions are not carried out

properly etc., most of these complaints can be avoided if the staff are able to spare sometime to retrieve the Information from books which is a time consuming process. By computerising the operations at the branch level even partially, there will be a remarkable improvement in meeting the expectations of the customers on line information can be provided to the queries, balancing is almost instantaneous, standing instructions are carried out automatically, legibility in entries, review/ renewal of limits on day to day basis etc., are some areas where computers can be effectively used. Manpower resources can be effectively put to use for business development and for better customer service and recovery of loans rather than spending on retrieval of information. After completing the process of computerising the branches we can provide a terminal at the customer site itself.

Banks have been modernising their Administrative Offices for fast decision making purposes credit proposal, performance review etc., can be transmitted through EDI by interconnecting their Regional/Zonal Offices with H.O. for speedy disposal of proposals. Head Office of the Banks should move towards sharing of information from single source (Data Centre) for this purpose all the sections in the H.O should be net world so as to access information from a single Data base. Information across the sections should be only through terminals. On attaining this level at the Corporate Office, the focus should be on hooking upto their next layer (i.e., COLZO) to have free and fast access of the data. All the necessary papers can be transferred through EDI or through leased lives without loss of time in making for faster and efficient decision making at various levels of the Hierarchy of a Bank.

15.4. BRANCH AUTOMATION :

The salient features of total automation on full completion would be

1) Teller Counter : All cash transactions for any account within teller limits are serviced in 2-3 minutes. The customer can walk upto any teller counter.
2) Single Window : Service for non-cash transactions like opening an account, giving standard instructions, taking a cheque book, depositing cheque for clearance etc.,
3) Cheque clearance is effected right at the commencement of the business hours, clearing cheques are debited to the accounts automatically. Interest credit/debit and standing instructions are effected right on due dates to know the latest position of any account at all counters.
4) Instant availability of information will enable the bank to offer Tele Banking facilities.

OBJECTS OF AUTOMATION OF A BRANCH ARE AS FOLLOWS :

- Maximising customer satisfaction
- Increasing availability of Information
- Improving Management Control through discrete monitoring and exceptional reporting
- Eliminating duplication and drudgery in work
- Gaining a competitive edge in service delivery by harvessing the power of Information Technology
- 24 hours banking facility through installation of ATMs.

Corporate clients of the Branch are having the privilege of terminals at their office connected to main computer at the branch for on line queries and giving instructions. Fully automated branches in all major cities will be connected through inter-city and intracity networks. Any customer of these branches will be able to transact business through any of these branch Electronic Funds Transfer among the fully automated branches is possible instantaneously.

15.5. CHANGING DYNAMICS IN THE BANKING INDUSTRY :

Banking is vital to a healthy economy. Banking as a business can be sub divided into five broad types : Retail, Domestic, Wholesale, International Wholesale, Investment and Trust of all these types, retail and Investment Banking are most affected by online technological innovations and are the ones that stand to profit most from Electronic Commerce.

The role of Electronic Commerce in banking is multifaceted - impacted by changes in technology, rapid deregulation of many parts of finance the emergence of New Banking institutions and Basic Economic restructuring. In the light of these changes, Banks are reassessing their cost and profit structures. Many Banks feel that inorder to be profitable they need to reduce operating expenses and maintain strict control. This philosophy is evident in the many mergers and acquisitions occuring in the Banking industry. The challenge behind bank restructuring lies in adequately operationalising the idea of cost control.

Technology is the predominant solution for controlling costs. Banks are increasingly turning toward Technology to help, reduce operating costs and still provide adequate customer service. Innovation and technology are becoming the key differentiators in the Financial Services Business. Advances in networking, processing and decision analytics have allowed institutions to lower service costs. Technology has also accelerated the pace of product innovation. For example, sophisticated arbitrage instruments like derivatives are changing the nature of investment banking. The Securities and Exchange Commission's decision to allow companies to trade its stock online may also fundamentally change investment banking by dis intermediating the traditional role of underwriting.

Technology is enabling the development of new products and services. For example, technology is capable of replacing or expediting tedious financial exercises like cheque writing, filing taxes and transferred funds. Although large business have automated these tasks, many small business and most households still do them manually. This is not surprising, large business have been undergoing computerisation for the last few years, whereas PCs have been entering households in significant numbers only in the last few years.

Technology is changing the interaction between banks and consumers. In particular, technological innovations have enabled the following capabilities. On line delivery of bank services and marketing information, Electronic access to bank statements, ability to request the transfer of funds between accounts. Electronic Bill payment and presentment, ability to use multiple financial software products with "Memory" (Thus eliminating the need to reenter the same data) online payments-encrypted credit cards for transfering payment instructions between merchant, bank, customer and finally micropayments. These online capabilities increase the facility and speed of retail banking.

However, new technology is a double edged sword, while it enables banks to be more competitive through large investments, it also enables new competition from fast moving, non banking companies. This trend can be seen in the area of online payments where recent innovations have provided an opportunity for non-banks to break into the banking business, threatening the banking stronghold on one of the last key services provided by banks. The present nature of online payments is a clear indication that if the banking industry fails to meet the demand for new products, there are many industries that are both willing and able to fill the void.

Technology also creates problem in the product development life cycle. In the past banks had the luxury of long roll out periods because successful investment in retail banking required a large monetary commitment for product development. This financial requirement prevented new participants from entering the market and was a key determinant of success. Instead of single institution doing every-thing, technology allows the creation of a “VIRTUAL FINANCIAL INSTITUTION” made up of companies, each contributing the best of breed software or products to the overall product. In this new “Virtual Model”, Banks compete with the twelve-to-eighteen month product development times of companies like Netscape which have product life cycle times of only six to nine months.

Clearly, the impetus for drastic change in the Banking Industry does not come from forces within banking. It is from competitive pressure outside the Industry.

In recent years, there has been a major change in the way banks strive for incerased profitability. In the past, the Banking Industry was chiefly concerned with asset quality and capitalization. If the Bank was performing well along these two dimensions, then the bank would likely be profitable. Today in the Global Scenerio, performing well on Asset quality and capitalization is not enough. Banks need to find new ways to increase revenues in a “Mature Market” for most traditional banking services, particularly consumer credit. A thorough understanding of this competitive Environment is needed before banks can determine their online strategy. Five distinct factors contribute to the New Competitive Environment.

- changing consumer needs driven by online commerce.
- optimisation of Branch Networks in order to reduce costs.
- changing demographic trends and potential new cosumer markets.
- cross industry competition caused by deregulation.
- New online financial products.

15.6. TECHNOLOGY BASED FINANCIAL SERVICES, PRODUCTS :

The growing importance of computer technology is another factor complicating predictions about the future structure of banking. Some experts believe that additional development of electronic cash such smart cards could stimulate further banking consolidation. They point to the fact that the start up costs associated with electronic payments technologies can be high, in part because electronic cash requires large investments in Computer Software and other resources to establish a Network of Secure Electronic Transactions. The development of Electronic Banking might actually increase competition in banking markets and lower bank operating costs. Electronic Banking

offers an inexpensive alternative to branching to expand a bank's customer base and many banks are using Electronic Banking to increase service to their customers. Many banks have started websites on the Internet and many plan to offer banking services over the Internet. Some banks are already offering certain banking services over the telephone. Smart cards and other forms of electronic cash could be the key to consumer acceptance of Home Banking, eventually allowing banks to reduce the number of their physical branches.

15.7. BANKING VIA ONLINE SERVICES :

Although Personal Finance Software allows people to manage their money. It only represents half of the Information Management Equation. No matter which software package is used to manage accounts information gets managed twice-one by the consumer and once by the bank. If the consumer uses personal Finance Software, then both the consumer and the bank are resposible for maintaining systems. Unfortunately these systems do not communicate with one another thus giving new meaning to double entry book keeping. For example, a customer enters data once into his system and transfers this information to paper in the form of a check only to have the bank then transfer it from paper back into electronic form.

15.8. MANAGEMENT ISSUES IN ONLINE BANKING :

The challenge facing the Banking Industry is whether management has the creativity and vision to harness the technology and provide customers with new financial products necessary to satisfy their continually changing financial needs. Banks must deliver high quality products at the customers convenience with high tech, high touch personal and affordable service. In order to achieve this Bank Managements have to balance the five key elements that increasingly drive customers Banking decisions. Simplicity, customized service, convenience, quality and price.
Online Banking will realise its full potential when the following key elements fall in place :

- The development of an interesting portfolio of products and services that are attractive to customers and sufficiently differentiated from competitors.
- The creation of on line financial supply chains to manage the shift from banks as gatekeeper models to banks as gateways.
- The emergence of low cost interactive access terminals for the home as well as affordable interactive home formation services.
- The identification of new market segments with untapped needs such as willingness to pay of remote banking.
- The establishment of good customer service on the part of banks. The fact that technology increases the ease of switching from one bank to another means that banks that do not offer superior customer service may see low levels of customer loyalty.
- The Development of effective back-office systems that can support sophisticated retail interfaces.

15.9. COMPONENTS OF MODERN BANKING M.I.S. :

Most of the Modern Banks are intending to reduce the number of channels for collecting data and move towards a centralised data collection and management. In order to cater to the needs of customers more sophisticated products are being introduced and they are as follows :

♦ **ATM :** This stands for Automatic Teller Machine. This is increasingly becoming popular in the Banking Industry. According to International Dictionary of Finance ATM is a computerized machine used for banking transactions, e.g. paying or withdrawing money statement enquiries and transfers, operated by magnetic plastic cards and Personal Identification Numbers (PINs) BARCLAYS Bank, London in 1967 installed the first in the world. In India HSBC which installed its first ATM in 1987. There are more than 10 Lakhs ATM worldwide while in India it is around 5000. There is a spurt in the installation of ATMs in India now thanks to liberalisation and competition. It is expected that the number of ATMs in India will exceed 35,000 by the end of 2004.

FUNCTIONS PERFORMED BY ATM :

- It can perform both cash and not-cash transactions in a totally Secured Environment.
- Cash transactions for both Deposits and Withdrawals some of the non cash transactions include.
- Mini statement of last 5 transactions. Some banks provide upto 10 transactions.
- Balance enquiry.
- Stop payment Instructions.
- Transfer of Funds between accounts.
- Requisition for Cheque book/Drafts.
- Bill payments.

OTHER FUNCTIONS :

- Dispensing Travellers Cheques.
- Smart Card based applications.
- Web enabled activities.
- Issue of Railway/Air tickets.

Besides the above, all Banks provide special boxes in all ATM outlets for disposal of cheques in the bank. The withdrawal in ATM is restricted to a certain limit per transaction per card as fixed by individual banks. Most of the banks are permitting to withdraw Rs. 15,000/- at a stretch. There are also on line and off line ATMs. The off-line ATMs have lower ceiling for cash withdrawal. The ceiling for the amount of cash deposit is determined in terms of notes and not value. Normally, maximum 50 notes is accepted for cash deposit. Banks have placed covers in their ATM outlet for deposit of cash. ATMs though do not count cash deposits gives a receipt for the cash accepted by it. For this purpose the customer is required to slide his card into the machine as he does for cash withdrawal. State Bank of India has recently introduced floating ATM in Kerala considering the cost of installation of ATM and the benefits for customers there is a need for increasing the number of hits per day in ATMs.

15.10. V.SATS :

This stands for very small operature terminals. It is a satellite based communications systems linking a number of branches in different locations. Vsats are relatively new technology. It was first introduced in the U.S.A in 1984. In India, privately run Vsat services started from March

1995. The National Stock Exchange is the most prominent organisation which uses a Vsat based communication system in India.

A V. Sat based system consists of three parts. The Vsats themselves are small fixed earth station. There is a large Earth station called "Hub" which controls the net work and finally there is a satellite through which the Vsats link up with each other. A Vsat to Vsat communication typically involves what is known as a double hop. A Vsat from a particular location sends a signal to a Satellite. This is known as uplinking the signal is then down linked to the Central Bank station or Hub uplinked again to the satellite and finally down linked to another Vsat. The role of the hub is to control and monitor this whole process. There are other types of Vsat technology now available which allow Vsats to link directly with each other without using the Hub, thus avoiding the double Hop. However, the hub monitors the signal between the two Vsats connectivity with the Public Phone network is not allowed.

There are companies which run Vsat services just as companies offer cellular services. The Vsat operator owns and runs the Hub. Usually, companies or large organizations and banks particularly with multiple locations would be interested in subscribing to a Vsat service. The most common is what is known as a shared hub service in which a large number of users or subscribers. It is also possible for a bank to buy and operate its own, there by it ensures speedy flow of information to banks. Vsats are only allowed to access Indian Satellites. They were also allowed to use only a part of the frequency spectrum known as extended band. Recently they have been allowed to use the key frequency band. These have acted as a serious constaint in the growth of the Industry because of the delay in sending Indian satellites into orbit. Satellite communications have definite advantage to banks as information can be collected very easily monitoring and controlling of funds is possible. Settlement of DD's are possible quickly. Inter Branch/Bank transactions can be done very quickly. Fraud prevention is possible. Quick decision making is possible due to fast communication.

15.11. VIRTUAL BANKING :

Oxford Dictionary defines the word "Virtual in the following terms" that (which) is so in essence or effect although not formally or actually. The mirror image is known as Virtual image. In a virtual reality what we see and what we feel is by no means real Virtual Banking would mean any b anking service delivered to the customer by means of a computer controlled system that does not directly involve the usual bank's branch. In essence in a Virtual Bank the traditional paradigm of a customer's integration with bank is replaced by an electronic paradigm which is new and innovative.

Customer demand, commercial motivationand technological developments have been the key drivers of Virtual Banking. In the changing environment adaptation to market realities as well as technology is causing the Virtual Banking Revolution. Thus virtualisation is driven by twin engine of customer pull and bank push.

Virtual Banking is a recent development in banking with the entire history of banking. The reasons for increase in virtual banking could be traced to the following main factors.

- The use of computers as accounting tool and also as a tool to expand and improve customer service.

- ♦ The routine banking transaction was becoming both costly and time consuming. The banks restored to computerisation to cust cost and time overheads in handling routine transactions.
- ♦ The introduction of Automated Teller Machine (ATM) imparted flexibility to bank customers and gave further filip to Virtual Banking.
- ♦ The introduction of Credit cards and Debit cards helped both the customers and retailers to be free from cash handling. These payment systems are saving time and offered security in its wake.

ATMs include shared ATMs, Electronic Funds transfer using Credit/Debit cards, Smart cards, Internet Banking are the different types of services under Virtual Banking.

BENEFITS TO BANKS :

- Larger satisfied customers and consequently higher customer retention rates.
- Possibilities of attracting new customers.
- More scope to improve quality and differentiate services.
- Greater opportunities to cross sell.
- Greater operational/customer base.
- Saving on cost of developing system through sharing of Network.
- Lower operating costs.
- Opprotunities for making profits through increasing profitable business segments like loan, remittances, low cost deposits etc.
- Reduce overall risk to the Institution handling transaction.

BENEFITS TO CUSTOMERS :

- More convenience.
- Better knowledge of staze of account.
- Wider range of products/services available to customers.

As regards the strategic challenge posed by the Virtual Banking, the banks have to ensure the following service standards.

- The service must be error free and accurate.
- The bank has to adopt new attitude towards customer service, putting the customer at the centre of their attention.
- The bank will have right type of people to face the emerging challenges in banking service.
- With the emphasis on Virtual Banking, the bank will have to make use of its branch network for so much for routine transaction but for selling more profitable products such as loans and investment products.

15.12. INFORMATION TECHNOLOGY ACT, 2000 :

This Act was enacted on the 9th June 2000, Providers Legal Environment and recognition to transactions carried out by means of Electronic Data Intercharge (EDI) or through any electronic medium including the Internet. This means their contracts entered into using electronic medium

like E-mail can now be enforced. The I.T Act ensures that records can also be kept in an Electronic form. Before the I.T. Act,. contracts could only be enforced if documents are signed. The law non recognises digital signatures. Digital signature means the authentification of an electronic record by a person using electronic means. The word “Electronic” in the Act refers to all kinds of Computer Systems.

The role of a banker in the E-Commerce is very important. The Banker Acts as a facilitator and transfers funds from one Account to another Account. In the absense of enforceable contracts e-commerce carried out over the Internet. Suppose a company wants all its financial transactions through Internet. It wants to have a connection with the local bank which will be covered by wide area net work. In case of any lapse on the part of banker the company has to prove the transaction under I.T. Act. The I.T Act therefore helps to increase the business to bankers as well as companies in the form of E-Commerce. The Act also seeks to encourage Electronic governance by allowing Government records to be kept in an Electronic form. The Act also permits banks to accept requisitions for cheques filing, of applications, etc.

The Controller of certifying authorities is part of the regulatory structure. For the first time the Act also defines cyber crimes which includes hacking into a computer network.

The centre will appoint adjudicating officers to decide whether or not a cyber crime has been committed. The adjudicating officer will have the right to award compensation not exceeding 10 lakhs. The decisions of the Adjudicating Officers can be challenged before the Cyber Law Appellete Tribunal a new body created by the Act. Decisions of the Appellate Tribunal can inturn be appealed to the High Court. The I.T. Act provides for a minimum imprisionment for three years or a maximum fine of Rs. 2 lakh or both.

15.13. KEY WORDS :

1. V.SAT : Very Small Apeture Terminal
2. A.T.M : Automatic Teller Machine
3. Virtual Banking : This is banking ‘Q’ in an environment other than the branches
4. Certifying Authority : A third party to certify that the document is authentic
5. I.T. Act : Information Technology Act 2000
6. Cyber Crime : A crime that takes place through Internet.

15.14. SELF - ASSESSMENT QUESTIONS :

1. Explain how the Information Technology helps in Banking Industry ?
2. What are the advantages of Branch Automation ?
3. Define M.I.S. Explain its role in Banking Business.
4. Discuss about the changing dynamics in the Banking Industry.
5. Explain about Technology based Financial Services.
6. Discuss about Management issues in online Banking.
7. Explain how the Vsats helps in increasing the efficiency of Modern Banks.
8. What is Virtual Banking and its benefits to customers ?
9. Discuss about Information Technology Act 2000.

15.15. SUGGESTED READINGS :

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2. Electronic Commerce A Managerial Perspective EFRAIM TURBAN, JAE LEE, DAVID KING, H. MICHAEL CHUNG, Pearson Education Asia.
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Lesson - 16

DIVERSIFICATION OF BANKING BUSINESS IN INDIA

OBJECTIVES :

- to understand the causes for diversification of financial activities by Commercial Banks
- to examine various types of financial activities and their operations by banks
- to underline the importance of Research and Scope for Research in Banking Industry.

STRUCTURE :

16.1 Introduction
16.2 Financial Services
16.3 Causes for Diversification of financial activities by Banks
16.4 Financial Engineering
16.5 Origin
16.6 Services of Merchant Banks
16.7 Qualities of Merchant Bankers
16.8 Guidelines of Merchant Bankers
16.9 Scope for Merchant Banking in India
16.10 Introduction
16.11 Types of funds / classification of funds
16.12 Objectives and Merits of Mutual funds
16.13 Short comings of mutual funds
16.14 Importance of mutual funds
16.15 Risks of mutual funds
16.16 Mutual Funds in India
16.17 Future of mutual funds industry
16.18 Concept and meaning
16.19 Modus operandi
16.20 Terms and conditions in Factoring
16.21 Functions of factoring
16.22 Types of factoring
  16.22.1 Benefits of factoring
16.23 Factoring in India
16.24 Concept and Definition
16.25 Working of Forfaiting
16.26 Cost of Forfaiting
16.27 Benefits of forfaiting
16.28 Drawbacks of forfaiting
16.29 Forfaiting in India
16.30 Introduction
16.31 Concept and Evolution

16.32 Development of Leasing
16.33 Types of Lease
16.34 Advantages of Lease
16.35 Disadvantages
16.36 Structure of Leasing Industry
16.37 Problems of Leasing
16.38 Future Prospects
16.39 Concept and Meaning
16.40 Features of Venture Capital
16.41 Stages of Venture Capital
16.42 Importance of Venture Capital
16.43 Development and Initiative in India
16.44 Venture Capital firms in India
16.45 Suggestion for the growth of Venture Capital funds
16.46 Introduction
16.47 Developments in Banking Sector
16.48 Banks in Insurance Business
16.49 Introduction
16.50 Emerging Universal Banking
16.51 Scope for Research in Banking Industry
16.52 Personnel Research in Banks - Importance
16.53 Scope for Research in Banking
16.54 NIBM
16.55 IBA
16.56 IDRBT
16.57 Key Words
16.58 Self - Assessment Questions

16.1 INTRODUCTION :

The Indian Banking Industry has undergone a metamorphosis since 1990. During the late seventies and eightees, the Indian Financial services industry was dominated by commercial banks and other financial institutions which later to the requirements of the Indian industry. Infact, the capital market played a secondary role only. The economic liberalisation has brought in a complete transformation also is getting gradually internationalised. One of the major beneficaries of liberalisation of the economy has been the banking industry and the banks have been on the policy of diversifying into different types of business activities.

Of late, the entire banking industry has undergone a sea change and now weare witnessing the emergence of new financial products and services. Thus, the present scenario is charaterised by financial innovation and financial creativity.

16.2 FINANCIAL SERVICES :

In general, all types of activities which are of a financial nature could be brought under the term 'Financial Services'. The term financial services in a broad sense means 'mobilising and allocating savings'. Thus, it includes all activities involved in the transformation of saving into investment. The financial service can also be called 'Financial Intermediation'. It is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Therefore, financial services sector is a key area and it is very vital for industrial development. A new developed financial services industry is absolutely necessary to mobilise the savings and to allocate them to various investable channels and thereby, to promote industrial development in the country.

16.3 CAUSES OF DIVESRSIFICATION OF FINANCIAL ACTIVITIES BY BANKS :

The commercial banks have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market price. It has become adire necessity for the banks to go for diversification of their financial activities.

i) Low Profitability :

The profitability of the commercial banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So they have been compelled to seek out new products which may fetch high returns.

ii) Keen Competition :

The entry of many financial institutions including banks in the financial sector market has led to severe competition among themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to the different requirements of the investors.

iii) Economic Liberalisation :

Reform of the banking sector constitutes the most important component of India's programme towards economic liberalisation. The recent economic liberalisation measures have opened the door to foreign competitors to enter into our domestic market.

iv) Improved Communication Technology :

The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into to the domestic market in no time.

v) Customer service :

Now a days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the exisitng ones. To meet this increased customer sophistication, the banks are constantly undertaking research in order to invert a new product which may suit the requirements of the investing public. Innovations thus help them in soliciting new business.

vi) Global Impact :

Many of the providers and users of capital have changed their roles all over the world. Banks have come out of their traditional approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

vii) Investor Awareness :

With a growing awareness among the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc., to financial assets like shares, debentures, mutual funds etc. Again, with in the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

16.4 FINANCIAL ENGINEERING :

Financial Engineering is a multi disciplinary approach to the management of risk and return which involves the use of derivative instruments to decompose standard financial transactions into their elements and then symthesise these elements into innovative cross market structures customised to the particular requirements of counter parties.

Financial engineering is frequently used to exploit anomalies in the tax, accounting and regulatory frameworks with in which markets operate. It is therefore conducted by teams which bring together traders, financial analysts, syndication staff, corporate finance officers, lawyers, tax specialists, accountants, etc., It involves the application of derivative instruments such as swaps and options. The growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. Financial engineering is the life blood of any financial ability. "Financial engineering the design, the development and the implementation of innovative financial instruments and process and the formulation of creative solutions to problems in finance".

Aspects of Diversification of Banking Business :

In recent years, the importance of Indian financial services is gaining momentum all over the world. In these days of complex finance, people expect banks to play to a very dynamic role. With the injection of the economic liberalisation policy into our economy and the opening up of the economy to multinationals, the free market concept has assumed much significance. As a result of innovations, new instruments and new activities are emerging in the banking industry. Following are some of the diversified banking business activities and functions being provided by modern commercial banks and they are discussed here.

MERCHANT BANKING

OBJECTIVES :

- To understand the origin and the services provided by Merchant Bankers
- To know the qualities of Merchant Bankers
- To learn the guidelines to operate Merchant banking business and examine the scope for merchant banking business in India.

Structure :

16.5 Origin
16.6 Services of Merchant Banks
16.7 Qualities of Merchant Bankers
16.8 Guidelines of Merchant Bankers
16.9 Scope for Merchant Banking in India.

16.5 ORIGIN :

Merchant Banking may be defined as "an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance etc"., The Merchant banker is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor to such issue management.

In India, prior to 1956, managing agents acted as issue houses for securities, evaluating project reports, planning capital structure and to some extent provided venture capital for new firms. The need for specialised merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The merchant banking services were started by foreign banks, namely, the National Grindlays Bank in 1967 and the City Bank in 1970. Banking commission also recommended in 1972 for launching Merchant Banking activities by commercial banks. The State Bank of India was the first Indian Bank to set up Merchant Banking Division in 1972. Later, ICICI set up its Merchant Banking Division followed by IDBI, Bank of India, Bank of Baroda, Canara Bank, Pubjab National Bank, UCO Bank and many other banks and financial institutions.

16.6 SERVICES OF MERCHANT BANKS :

The Corporate sector enterprises raise the finances through the issue of shares and debentures in the capital market. The companies bank upon merchant bankers who manage the whole show by rendering multivarious services which are discussed hereunder.

i) Corporate Counselling :

Corporate Counselling covers the entire field of merchant banking activities i.e., capital restructing, public issue management, project management, loan syndication, working capital, acceptance credit etc. The scope of this function is limited to giving suggessions and opinions to the client and help taking actions to solve their problems.

ii) Project Counselling :

This includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the banks. Project reports are prepared to obtain governmental approval, get financial assistance from institutions and plan for the public issue. Project counselling also includes filling up of application forms with relevant information for securing funds.

iii) Loan Syndication :

It refers to assistance rendered by merchant banks to get mainly term loans for projects. Merchant bankers help corporate clients to raise syndicated loan from commercial banks. The decision as to which financial institution / bank should be approached depends on industry, location of the unit and size of the project cost. Merchant Banker makes an appraisal of the project and design the capital structure, determine the promoter's contribution and arriving at a figure of approximate amount of term loan to be raised. The merchant banker has to ensure that the project adheres to the guidelines for financing industrial projects.

iv) Issue management :

Management of issue involves marketing of corporate securities viz., equity shares, perference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it. The issue function may be broadly divided into pre issue management and post issue management. In both the stages, legal requirements have to be complied with the several activities connected with the issue have to be coordinated. The pre issue management is classified into four stages which are discussed here under.

a) Public issue through prospectus :

The most common method of public issue is through prospectus. The company sells the entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value. The direct sale of securities by a company to investors is called Private Placement. The investors include LIC, UTI, GIC, SFC etc. To bring a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professional and private agencies, legal advisers etc., It is only after clearance by SEBI, the prospectus can be filed with registrar of companies. Bankers to the issue accept applications along with subscriptions tendered at their designated branches and forward them to the Registrar.

b) Marketing :

After despatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching of publicity compaign. Publicity campaign covers the preparation of all publicity material and brouchers, prospectus, advertisement in the press, radio, TV., etc., The merchant bankers help in chooosing the media, determing the size and publication in which the advertisement should appear.

The Merchant banker has to ensure that the material is delivered to the stock exchange atleast 21 days before the issue opens and the brokers to the issue, branches of brokers to the issue and the underwriters on time. Security issues are underwritten to ensure that in case of under subscription the issues are taken up by the underwriters. Various activities connected with the pre issue management are a time bound programme which has to be promptly attended to.

c) Pricing of Issues :

SEBI guidlines of 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. The premium has to be decided after taking into account the net asset value, profit earning capacity and market price.

d) Post issue Management :

The post issue management consists collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedure, mailing of allotment, letters, shares certificates and refend orders. Registrars to the issue play a major role in post issue management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. They have to ensure that the applicasions are processed and allotment / refund orders are sent with in 70 days of the close of the issue.

v) Underwriting of public issue :

Underwriting is a guarantee given by the underwriter that, in the event of under subscription the amount underwritten would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. Underwriting enables the issuing company to sell securities quickly. By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

vi) Managers, consultants or Advisers to the Issue :

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. SEBI guidelines insist that all issues should be managed by atleast one authorised merchant banker. Normally, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over Rs. 100 crores, upto a maximum of four merchant bankers could be associated as managers.

vii) Portfolio Management :

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. It refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Every investor is interested in safety, liquidity and profitability of his investment. But investors can not study and choose the appropriate securities. They need expert guidance. Merchant bankers have to conduct regular market and economic surveys and know about the financial position of the companies, secondary market position and the competition faced by the industry with similar type of industries etc., The merchant bankers have to analyse the surveys and help the prospective investors in choosing the shares. The portfolio managers generally will have to classify the investors based on capacity and risk, they can take and arrange appropriate investment.

viii) Advisory Service Relating to Mergers and Takeovers :

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Merchant banker appraises merger / take over proposal with respect to financial viability and technical feasibiilty. He negotiates and get approval from the RBI and government, draft scheme of amalgamation and obtains approval from financial institutions.

ix) Off shore finance :

The Merchant bankers help their clients in the following areas involving foreign currency -

- long term foreign currency loans
- joint venture abroad
- financing exports and imports and
- foreign colleboration arrangements

The banker render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

Non Resident Investment :

The services of merchant bankers include investment advisory services to NRI's in terms of identification of investment opportunities, selection of securities, investment management etc., They also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

16.7 QUALITIES OF MERCHANT BANKERS :

Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures. They help promotion of the enterprise by undertaking various activities such as market surveys, choice of suitable location and its size, preparation of documents and obtaining constent from various authorities. They help taking important decisions such as financing mix, management of public issues, credit syndication etc. The success of the merchant bankers depends on the quality of service and soundness of advice to clients. To perform these services effectively, the merchant bankers should possess certain qualities which are given below :

- Ability to analyse various aspects such as technical, financial and economic aspects concerning the formation of an industrial project.
- Knowledge about various aspects of capital markets, trends in stock exchange, psychology of investing public, change in the economic and technological environment in the country.
- Ability to build up the bank-client relationship and live up to the clients expectations with total involvement in the project assigned to them.
- Integrity and maintenance of high professional standards are the essential requisites for the success of merchant bankers and
- Innovative approach in developing capital market instruments to satisfy the ever changing needs of investing public.

16.8 GUIDELINES FOR MERCHANT BANKERS :

Merchant banking has been statutorily brought within the framework of the Securities and Exchange Board of India (SEBI) Regulations 1992. All merchant bankers require authorisation from SEBI to carry out their business. The SEBI classified the merchant bankers into four categories based on the nature and range of activities and their responsibilities to the investors and issuers of securities. It has prescribed a code of conduct to the merchant bankers. They must perform their duties with highest standards of integrity and fairness in all their dealings with investors, clients and fellow bankers. SEBI has been vested with power to suspend or cancel the authorisation in case of violation of the guidelines.

Inspections will be conducted by SEBI to ensure that provisions of the regulations are properly complied with and to investigaet the complaints from customers. It is obligation on the part of merchant bankers to furnish all the details sought by the investigation team. The SEBI would advice merchant bankers to take any measures, that if may deem fit, and to comply with the provisions of the regulations. With the revised changes in SEBI rules and regulations in 1997, only the corporate bodies will be allowed to function as merchant bankers. Moreover, the multiple categories of merchant bankers shall be abolished and there will be just one entity i.e., Merchant Banker. The SEBI has felt that merchant bankers must be involved more closely in the market making process as share brokers do not have the requisite expertise to evaluate the fundamentals of the scrips before taking over the role of market makers.

16.9 PROGRESS OF MERCHANT BANKING IN INDIA :

Upto 1970, there were only two foreign banks which performed Merchant banking operations in the country. SBI was the first Indian Bank and ICICI the first financial institution to take up the merchant banking activities in 1972 and 1973 respectively. Later, a number of large stock broking firms and financial consultants also entered into business. Thus, by the end of 1985, there were 33 merchant bankers belongs to three major segments viz., Commercial banks, all India financial institutions and private firms. Merchant banking industry which remained almost stagnant for over two decades, witnessed an artonishing growth after the process of economic reforms and deregulation of Indian economy in 1991. The number of merchant banks increased to 115 by 1992-

93 300 by 1993-94 and 501 by 1995. In addition to Indian merchant bankers, a large number of reputed international merchant bankers like Merrill Lynch, Morgen stanley, Goldman sachs etc., are operating in India with the permission of SEBI. As a result of poliferation, Indian merchant bankers are faced with severe competition not only among themselves but also with the well developed global players.

SCOPE FOR MERCHANT BANKING IN INDIA :

In the present day capital market scenario, the merchant banks play the role of an encouraging and supporting force to the entrepeneurs, corporate sectors and investors. Following are the aspects responsible for vast scope of merchant banking business in India.

i) Growth of new issues Market :

The growth of new issue market is unprecedented since 1990-91. The number of capital issues has increased from 363 in 1990-91 to 900 in 1993-94. The amount of annual average of capital issue in the first four years 1990s was Rs. 12,700 covers and this figure could be well beyond Rs. 16,372 crores in 1995-96.

ii) Entry of Foreign Investors :

An outstanding development in the history Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian Companies to directly tap foreign capital through euro issues. The total inflow of foreign capital was $ 5 billion from 1992 to 1994. The foreign direct investments have risen drastically in recent years, due to the incentives offered by the government.

iii) Development of Debt Market :

The concept of debt market has set to work through National Stock Exchange and the over the Counter Exchange of India. Experts feel that of the estimated capital issues of Rs. 40,000 crores in 1994-95, a good portion may be raised through debt instruments.

iv) Changing policy of Financial Institutions :

With the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would require the expert services of merchant bankers for project appraisal, financial management etc., The policy of decentralisation and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by merchant bankers.

v) Innovation in financial instruments :

The Indian capital market has witnessed innovations in the introduction of financial instruments such as non convertible debentures with datachable warrants, cumulative convertible preference shares, Zero coupon bonds, deep discount bonds, triple option bonds, floating rate bonds etc., This has further extended the role of Merchant bankers as market makers for these instruments.

vi) Corporate Restructuring :

As a result of liberalisation and globalisation, the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning. This has led to corporate restructuring including mergers, acquisitions, splits, disinvestments and financial restructuring.

It can be pointed out the scope of merchant banking in vast and there lies immense opportunities ahead of merchant bankers. They should develop adequate infrastructure including expertise in order to provide full range of merchant services to corporate sector.

MUTUAL FUNDS

Objectives :

- To understand the concept of Mutual funds and their types
- To know the objectives and advantages of mutual funds
- To identify the short comings of mutual funds
- To examine the importance of mutual funds
- To know the future of mutual funds industry in India.

STRUCTURE :

16.10 Introduction
16.11 Types of funds / classification of funds
16.12 Objectives and Merits of Mutual funds
16.13 Short comings of mutual funds
16.14 Importance of mutual funds
16.15 Risks of mutual funds
16.16 Mutual Funds in India
16.17 Future of mutual funds industry

16.10 INTRODUCTION :

Of late, mutual funds have become a hot favourite of millions of people all over the world. The driving force of mutual funds is the safety of the principal guaranteed, plus the added advantage of capital appreciation together with the income earned in the form of interest or dividend. People prefer mutual funds to bank deposits, life insurance and even bonds because with a little money, they can get into the investment game. One can own a string of blue chips like ITC, TISCO, Reliance etc., through mutual funds. Thus, mutual funds act as a gateway to enter into big companies which are inaccessible to an ordinary investor with his small investment.

ORIGIN AND DEBINISION :

The origin of the concept of mutual fund dates back to the very down of commercial history. The credit of introducing mutual fund goes to the foreign and colonial government trust of London which came into being in 1868. Thereafter, a large number of close ended mutual funds were

formed in USA in 1930s followed by many countries in Europe, the Far East and Latim America. In India, it gained momentum only in 1980, though it began in the year 1964 with the Unit Trust of India launching its first fund, the unit scheme 1964.

The secutirities and Exchange Board of India (Mutual Funds) Regulations 1993 defines a mutual fund as "a fund established in the form of a turst by a sponsor, to raise monies by the trustees through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations". These mutual funds are referred to as Unit Trusts in the UK and as open end investment companies in the U.S.A., Thus, mutual funds are corporations which pool funds by selling their own shares and reduce risk by diversification.

WHAT IS A MUTUAL FUND ?

To state in simple words, a mutual fund collects the savings from small investors, invest them in government and other corporate securities and earn income through interest and dividends besides, capital gains. It works on the principle of "small drops of water make a big ocean". For example, if one has Rs. 1,000/- to invest, it may not fetch very much on its own. But, when it is pooled with Rs. 1,000/- each from a lot of other people, then, one could creat a 'big fund' large enough to invest in a wide varieties of shares and debentures on a commanding scale and thus, to enjoy the economies of large scale operations. Hence, a mutual fund is nothing but a form of collective investment. It is formed by coming together of number of investors who transfer their surplus funds to a professionally qualified organisation to manage it.

To get the surplus funds from investors, the fund adopts a simple technique. Each fund is divided into a small fraction called 'units' of equal value. Each investor is allocated units in proportion to the size of his investment. Thus, every investor, whether big or small, will have a stake in the fund and can enjoy the wide portfolio of the investment held by the fund. Hence, mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emered as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk.

16.11 TYPES OF FUNDS / CLASSIFICATION OF FUNDS :

These are different types of funds to cater to the vast requirements of all investors. It is left to the discretion of the investor to choose any one of them depending upon his requirements and his risk taking capacity. Mutual funds are classified on two counts as given below.

1) On the basis of execution and operation :

a) Close ended funds
b) Open ended funds

2) On the basis of yield and investment pattern

a) Income Fund
b) Growth Fund
c) Balance Fund
d) Specialised Fund

e) Money Market Fund
f) Taxation Fund

1) On the Basis of execusion and operation :

a) Close Ended Funds :

Schemes that have a stipulated maturity period (ranging from 2 to 15 years) are called close ended schemes. The corpus of the fund and the number of units are determined in advance. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding.

Features :

- The period and the target amount of the fund is fixed beforehand.
- Once the period is over and the target is reached, the door is closed for the investors and they cannot purchase any more units.
- These units are publicity traded through stock exchange
- At the time of redemption, the entire investment pertaining to a closed end scheme is liquidated and the proceeds are distributed.
- The fund ceases to be a fund after final distribution.
- The main objective of this fund is capital appreciation
- From the investor's point of view, it may attract more tax since the entire capital appreciation is realised in tofo at one stage itself.

b) Open ended funds :

It is just the opposite of close ended funds. Under this scheme, the size of the fund and the period of the fund is not predetermined. The investors are free to buy and sell any number of units at any point of time. For example, the unit scheme of 1964 of the UTI is an open ended one, both in terms of period and target amount.

Features :

- There is complete flexibility with regard to one's investment or disinvestment. The investor can join in and come out from the fund as and when he desires.
- These units are not publicly traded and the fund is ready to repurchase them and resell them at any time.
- The main objective of this fund is income generation. The investors get dividend, rights or bonuses as rewards for their investments.
- The investor is offered instant liquidity in the sense that the units can be sold on any working day to the fund.
- Generally, the listed prices of the units are very close to their Net Asset Value (NAV). The fund fixes a different price for their purchases and sales.

To put it in a nutshell, the open ended funds have a perpetual existence and their corpus is ever changing depending upon the entry and exist of members.

2) On the basis of Income and Investment pattern :

a) Income Funds :

This fund aims at generating and distributing regular income to the members on a periodical basis. The investor is assured of regular income at periodic intervals, half yearly or yearly. The main objective of this type of fund is to declare regular dividends and not capital appreciation. This fund is best suited to the old and retired people who may not have any regular income.

b) Growth Funds :

Unlike the Income Funds, growth funds concentrate mainly on long run gains i.e., capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. The investment strategy conforms to the fund objective by investing strategy conforms to the fund objective by investing the funds predominantly on equities with high growth potential. The fund tries to get capital appreciation by taking much risks and investing on risk bearing equiries and high growth equity shares. This fund is best suited to salaried and business people who have high risk bearing capacity.

c) Balanced Funds :

This is otherwise callled 'Income-cum-growth' fund. It is nothing but a combination of both income and growth funds. It aims of distributing by balancing the investments between the high growth equity shares and also the fixed income earning securities.

d) Specialised Funds :

These funds offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc., There are funds for investments in securities of specified areas. For example, Japan Fund, South Korea Fund etc., These funds open the door for foreign investors to invest on the domestic securities of these countries.

e) Money Market Funds :

These funds are basically open ended mutual funds and as such they have all the features of the open ended fund. But, they invest in highly liquid and safe securities like commercial paper, banker's acceptances, certificates of deposits, Treasury bills etc. These investments are called money market investments. They take the place of shares, debentures and bonds in a capital market.

Since money market funds are a new concept in India, the RBI has laid down certain regulations. For instance, the entry of money market funds is restricted only to scheduled banks and their subsidiaries. They can invest only in specified short term money market instruments like certificate of deposits, commercial papers etc., Frequent realisation of interest and redemption of fund at short notice are the special features of this fund.

f) Taxation Funds :

A Taxation Fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax

rebates. At present, the law relating to tax rebates is covered under section 88 of Indian Income Tax Act 1961.

There are other types of mutual funds which are given below :

- Leverage Funds
- Dual Funds
- Index Funds
- Bond Funds
- Aggressive Growth Funds
- Off shore mutual funds

In order, these funds are subject to the approval of the Govt. of India and the RBI. A number off shore funds exist in India. India Fund and India Growth fund were floated by the UTI in UK and USA respectvely. The State Bank of India floated the India Magnum Fund in Netharlands.

16.12 OBJECTIVES AND MERIT OF MUTUAL FUNDS :

The objectives of mutual funds are as follows :

1) To provide an investment opportunity for the investors, especially the small income group of people to participate in the growing corporate securities market in an indirect manner.
2) To provide a return that is more than bank deposit note, to the subscribers without corresponding rise in the level of risk.
3) To mobilise the savings of the public and channel them into productive investments.
4) To provide for different investment objectives like current return, capital appreciation, tax benefit
5) To strengthen the capital market by adding the mutual fund dimension to the same.

Following are the merits of mutual fund schemes :

- Safety of principal
- Stable and fair return
- Risk reduction and diversified portfolio
- Investors are relieved of the botheration of managing investments
- Broadbasing of capital market
- Benefit of professional skill of fund managers
- Capital formation takes effect
- Variety of schemes are available to choose from and some schemes have excellent liquidity
- Common investors are relieved of the problems of managing their portfolio themselves

16.13 SHORT COMINGS OF MUTUAL FUNDS :

Most of the mutual fund schemes lack liquidity. Liquidity means ability to realise the asset in cash without loss of value and time. By this yardstick, most schemes are illiquid. The stock exchange quoted schemes also suffer illiquidity since their prices are far below the published net assets value. Mutual funds are subject to market fluctuation. The problem is, in a growing market, mutual funds grow less than the market, as it should be. But in a declining market, they slide down

steeper than the market which should not be the case. At any point of time, sellers out number buyers in the case of mutual funds. This is due to 'upward rigidity' in a booming market and 'downward flexibility' of mutual fund values ina bearish market.

Mutual funds lack transparency. Safety net is not available i.e., many schemes quote below par value. Not all mutual funds are well managed. As the size of corpus rises, it seems value investment takes the back seat. Typical example is the Master gain 1992 scheme of UTI, which is a world record in terms of collection, but as to value one of the poorest performers. Even after 3 years since launching in May 1992, it has not grown beyond 50%. Morgan stanley mutual fund which was launched with lot of fanfare is again quoting down 30%of par value.

16.14 IMPORTANCE OF MUTUAL FUNDS :

The Mutual Fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. Following are some of the importance advantages of mutual funds.

1) Channelising savings for investment
2) Offering wide portfolio investment
3) Providing better yields
4) Rendering expertised investment service at low cost
5) Providing Research service
6) Offering Tax Benefits
7) Introducing flexible investment schedule
8) Providing greater affordability and liquidity
9) Simplified record keeping
10) Supporting capital market and promoting industrial development and
11) Keeping the money market active

16.15 RISKS OF MUTUAL FUNDS :

Mutual Funds are not free from risks. It is so because basically the mutual funds also invest their funds in the stock market on shares which are volatile in nature are not risk free. Hence, the following risks are inherent in their deelings.

- Market Risks
- Scheme Risks
- Investment Risks
- Business Risks
- Political Risks

ORGANISATION OF THE FUND :

The structure of mutual fund operations in India envisages a three tier establishment namely:

i) A sponsor institution to promote the fund
ii) A team of trustees to oversee the operation and to provide checks for the efficient, profitable and transperent operations of the fund and
iii) An Aspect Management Company (AMC) to actually deal with the funds.

The company which sets up mutual fund is called the sponsor. The SEB laid down certain criteria to be must by the sponsor. The trustee should have long experience and good integrity in their respective fields. The Asset Management Company (AMC) manages the funding the various schemes. It employs large number of professionals to make investments, carryout research and to do agent and investor servicing, In fact, the success of any mutual fund depends on the efficiency of the AMC.

A mutual funds invites the prospective investors to join the fund by offering various schemes so as to suit the requirements of different categories of investors. The resources of individual investors are pooled together and the investors are issued units / shares for the money invested. The amount so collected is invested in capital market instruments like shares and debentures and money market instruments like treasury bills, commercial papers etc.,

MUTUAL FUNDS ABROAD :

The mutual funds have been growing at an unprecedented pace throughout the world. In USA, mutual funds have been labelled as the bank deposits of 1990's. Mutual funds have changed the American financial landscape by offering a menu of investment choice and some companies like fidelity investments, vanguard are very popular among them. The Americans have been pouring in over $1 billion every day into these funds. In the US, today, nearly, 83 million investors forming 27% of the households save in 4558 funds and this industry has an annual growth rate of 20%.

The funds in UK have already crossed the 1000 mark by the end of 1987. The top 25 funds in growth sectors. Some of them have doubled their money with in a period of just one year. In Australia, these funds have been very successful particularly on account of 46.8% rise in Australian All share index. MFS are growing in size, and importance in countries like Hongkong, Singapore, Philippines, Thailand, South Korea etc.,

16.16 MUTUAL FUNDS IN INDIA :

In India, the mutual fund industry has been monopolised by the UTI ever since 1964. Now, the commercial banks like SBI, Canara Bank, Indian Bank, Pubjab National Bank, Bank of India etc., have entered into the field. To add to the list are the LIC, some private banks and other financial institutions and private corporate enterprises like taxes have launched MFs. UTI is the largest mutual fund company with over 25 million investors and a corpus exceeding Rs. 55,000 crores, accounting for nearly 10% of the country's stock market capitalisation. The total corpus of other 13 mutual funds in the country is less than Rs. 15,000 crores. The SBI fund has a corpus of Rs. 3000 crores deployed in its 16 schemes servicing over 2.5 million share holders. Now, there are about 25 mutual funds offering so different schemes and serving 60 million investors.

There are also mutual funds with investments sourced abroad called 'offshore funds' to attract NRI investments into the Indian Capital Market. The UTI, LIC and GIC have entered into foreign markets through their off share funds. The recent trend in the MF industry is to go for tie up arrangements with foreign collaborators. We find Tatas tying up with klein worth Benson, GIC with george soros, Kothari with pioneer. ICICI with JP Mogan etc., In India, MFs have been preferred as an avenue for investment by the household savers only from 1990s.

Reasons for Slow growth :

Of late, MFs find their going very tough. Most of the funds are not able to collect the targetted amount from small investors. Following are some of the problems faced by mutual funds.

i) Lack of Transparency
ii) Disparity between Net Asset Value (NAV) and listed price
iii) Poor investor servicing
iv) Too mcuh dependence on outside agencies.
v) Absence of qualified sales force.

16.17 FUTURE OF MUTUAL FUNDS INDUSTRY :

Inspite of the above bottlenecks, the MF industry is having a good prospect in our country. The SEBI is lending its full support for the promotion of the MF industry directly as well indirectly. In recent times, the interest rates on bank deposits have been declining. The household savers are looking for alternative avenues like MFS which could bring high returns. MFs provide a wide range of products so as to meet the diverse needs of the investing public. The government also has given the necessary impetus by providing tax concessions and tax exemptions. The govt. has taken many measures to encourage the MF industry in the country. All these factors would go a long way in making MFS an increasingly popular, lucrative and cost effective vehicle for investment. If MFs' ensure good returns quick liquidity and safety and credit a good report with the investors, their future will be very bright. No doubt, there is bright future for mutual funds industry in India.

FACTORING

Objectives :

- To understand the concept of factoring
- To know the modus operandi of factoring
- To examine the functions of factoring
- To outline the benefits of factoring and how factoring is developing in India.

STRUCTURE :

16.18 Concept and meaning
16.19 Modus operandi
16.20 Terms and conditions in Factoring
16.21 Functions of factoring
16.22 Types of factoring
16.22.1 Benefits of factoring
16.23 Factoring in India

16.18 CONCEPT AND MEANING :

The word 'factor' has been derived from the latin word 'facere' which means "to make or to do". In otherwords, it means 'to get things done'. According to the webster dictionary 'factor' is an

agent, as a banking or insurance company engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In otherwords, factoring is a continuous arrangement between a financial institution i.e., the factor, and a company i.e., the client which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the clients trade debts including accounts receivable either with or without recourse to the client and, thus experiences control over the credit extended to the customers and administers to sales ledger of his client. The client is immediately paid 80% of the trade debts taken over and when the trade customers repay thier dues, the factor will make the remaining 20% payment. In short, a factor is an agent who collects the dues of his client for a certain fee.

R.W. Johnson states “factoring is service involving the purchase by a financial organisation, called a factor of receivable owned to manufacturers and distributors by their customers with the factor assuming full credit and collection responsibilities”. According to V.A. Avadhani “factoring is a service of financial nature involving the convertion of credit bills into cash’. Factoring in an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables and then collects the amounts from the customers to whom the company has supplied goods.

16.19 MODUS OPERANDI :

A factor provides finance to his client upto a certain percentage of the unpaid invoiceces which represent the sale of goods or services to approved customers. The modus operandi of the factoring scheme is as follows :

i) These should be a factoring arrangement between the client and the factor, which is the financing organisation

ii) Whenever the client sells goods to trade customers on credit, he prepares invoices in the usual way.

iii) The goods are sent to the buyers without raising a bill of exchange but accompanied by an invoice.

iv) The debt due by the purchasers to the client is assigned to the factor by advising the trade customers, to pay the amount due to the client, to the factor.

v) The factor pays up to 80% of the assigned invoices and the balance 20% will be paid on realisation of the debt.

16.20 TERMS AND CONDITIONS IN FACTORING :

- Assignment of debt in favour of the factor
- Selling limits for the client
- Factor to have recourse in case of non-payment
- Interest to be allowed to the factor on an account where credit has been sanctioned to the supplier and
- Limit of any overdraft facility and the rate of interest to be charged by the factor.

16.21 FUNCTIONS :

Factoring involves the following functions.

1) Purchase and collection of Debts :

Factoring envisages the sale of trade debts to the factor by the company i.e., the client. The factor purchases the entire trade debts and he becomes a holder for value and not an agent. He also collects the debts.

2) Sales ledger management :

Once the factoring relationship is established it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain laison with the client and the customer to resolve all possible disputes.

3) Credit investigation and credit risk :

The factor has to monitor the financial position of the customer carefully, since he assumes the risk of default in payment by customers due to their financial inability to pay. Before accepting the risk, the factor has to investigate on the possibility of credit risk and then assumes.

4) Provision of Finance :

After the finanalisation of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business.

5) Rendering consultancy Services :

The factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and financial profiles of the customers.

16.22 TYPES OF FACTORING :

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc., The factoring services can be classified as follows :

a) Full service factoring
b) With recourse factoring
c) Maturity factoring
d) Bulk factoring
e) Invoice factoring
f) Agency factoring
g) International factoring

16.22.1 BENEFITS OF FACTORING :

Following are the benefits of factoring to the client companies.

- Financial services
- Credit risk services
- Provision of expertised sales ledger management service
- Consultancy services
- Economy in servicing
- Trade benefits

16.23 FACTORING IN INDIA :

Factoring which is very popular abroad and which is the answer to every company's cash flow problems is still in its nascent stages in India. The idea of providing factoring services was first thought of by the vaghul working group. It has recommended that banks and private non-banking financial companies should be encouraged to provide factoring services with a view to helping the traders to tide over their financial crunch arising out of delays in the relaisation of their book debts. On the recommendation of the committee set up by the RBI the Banking Regulation Act was amended in 1990 with a view to enabling banks to take up factoring services by forming separate subsidiaries. In 1994, the RBI has permitted all banks to enter into factoring business departmentally. Since factoring requires special skills and infrastructure, the RBI has stipulated that :

i) Factoring should be treated on par with loans and advances and should be given risk weight of 100% for calculation of capital to risk asset ratio.

ii) Factoring services should be provided only in respect of those which represent genuine trade transactions.

In India, the factoring service was first started by the State Bank of India in association with the Small Industries Development Bank of India (SIDBI), Union Bank of India, State Bank of Sourashtra and State Bank of Indore. It is called "SBI - Factors and commercial Services Pvt.Ltd (SBIFACS)". It was started in July 1991 with a subscribed capital of Rs. 25 crores. It has been alloted the western zone comprising Maharastra, Gujarat, Goa, Madhya Pradesh, Union Terrtories of Dadra, Nagar haveli, Daman and Dill. Similarly, the RBI has alloted the southern region to the Canara Bank, the Northern Region to the Pubjab National Bank and the Eastern Region to the Allahabad Bank for providing necessary factoring services to the clients of those regions. In south, Canara Bank has setup Can Factors Ltd. Besides, some non banking companies also have made a bid for entering into factoring services. Therefore, factoring service has got a very bright future in India due to its superiority over the other forms of financing.

The main factors impeding the growth of factoring services are that it is a fund based activity and without recourse to large funds, it would become difficult for many companies to operate effectively. Other problems are evaluasion of credit worthiness of clients and stamp duty etc., Since factoring is assignment of debt, it attracts stamp duty. While factoring may be a new concept in India, its is developed in western countries. For instance, in Europe, manufacturing sector accounts for 46.4% of the total business done by factors.

FORFAITING

Objectives :

- Understand the concept of Forfaiting
- To know the working process of forfaiting
- To examine the benefits and drawbacks of forfaiting
- To outline the process of forfaiting in India.

STRUCTURE :

16.24 Concept and Definition
16.25 Working of Forfaiting
16.26 Cost of Forfaiting
16.27 Benefits of forfaiting
16.28 Drawbacks of forfaiting
16.29 Forfaiting in India.

16.24 CONCEPT AND DEFINITION :

Forfaiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium term deferred basis. The term 'a forfait' is a french word denoting 'to give something' or 'give up one's rights' or relinguish rights to something'. In fact, under forfaiting scheme, the exporter gives up his right to receive payments in future under an export bill for immediate cash payments by the forfaitor. This right to receive payment on the duedate passes on to the forfaitor, since, the exporter has already surrendered his right for the forfaitor. Thus, the exporter is able to get 100% of the amount of the bill minus discount charges immediately and get the benefits of cash sale. Therefore, it is a unique medium which can convert a credit sale into a cash sale for an exporter. The entire responsibility of receiving the amount from the importer rests with the forfaitor. Forfaiting is done without any recourage to the exporter i.e., in case the importer makes a default, the forfaitor cannot go back to the exporter for the recovery of the money.

Forfaiting is defined as "the non recourse purchase by a bank or any other financial institution of receivables arising from an export of goods and services". It is generally employed to finance export business and it is always used for medium term financing at fixed rate of interest. Forfaiting is a specific one in the sense that it is based on a single export bill arising out of an individual transaction only.

16.25 WORKING OF FORFAITING :

In a forfaiting transaction, the exporter is the client and the financial institution is called the forfaitor and the importer is the debtor. When an exporter intends to export goods and services, he approaches a forfaitor and gives him the full details of his likely export dealing such as the name of the importer, the country to which he belongs, the currency in which the export of goods would be invoiced, the price of the goods and services etc., He discusses with him the terms and conditions of finance. If it is acceptable, a sole contract is signed between the exporter and the importer on condition that the payment should be made by the importer to the forfaitor.

As usual, bills or promissory notes are signed by the importer. Such notes are guaranteed by the importer's bank and forwarded to the exporter's bank. Generally, such notes would be released to the exporter only against shipping documents. When goods are exported, the shipping documents are handed over to the exporter's bank. The exporter's bank then forwards the shipping documents to the importer's bank after releasing the notes / bills to the exporter. These documents finally reach the hands of the importer through his bank. Thereafter, the exporter takes these notes to the forfaitor who purchases them and gives ready cash after deducting discount charges.

16.26 COST OF FORFAITING :

The cost of forfaiting finance in always at a fixed rate of interest which is usually included in the face value of the bills or notes. Of course, it varies depending upon the duration, credit worthinesss of the party, the country where the importer is staying, the denomination of the currency in which the export deal is to be done and overall political, economic and monetary conditions prevailing in the importer's country. Since the forfaitor has to assume currency fluctuation risk, interest rate fluctuation risk and the country's risk, he charges a fee and abviosly, it varies according to the risk factor involved in the deal.

16.27 BENEFITS OF FORFAITING :

Following are the advantages of forfaiting.

- It is advantageous because the forfaitor not only gets immediate income in the form of discount charges but also, can sell them in the secondary market or to any investor for cash.
- It is beneficial to exporter. It is simple and flexible and it can be adpted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and forfaitor.
- The exporter is completely free from many export credit risks that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations. It acts as an insurance against the risks.
- International trade transactions can be carried out quickly through a forfaitor. It does not involve much documentary procedures. The speed and confidentiality with which deals are made are very beneficial for both the parties namely the exporter and the importer.
- The exporter is able to convert his deferred transactions into cash transactions through a forfaitor. He is able to get 100% finance against export receivables.
- Forfaiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

16.28 DRAW BACKS :

Following the drawbacks of forfaiting.

- Forfaiting is not suitable for long period payments as it involves credit risks.
- Forfaitors generally do not come forward to undertake any forfait financing deal involving an importer from a financially weak country. They do not accept a deal if the importer stays in a risky country.

- In international transactions, forfaiting is done in leading western currencies like dollars, pounds, sterling, French francs etc.,
- Forfaitors do not finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfaitor. Generally, it is the duty of the exporter to procure a guarantee of this kind.

16.29 FORFAITING OF INDIA :

Forfaiting as a source of finance has gained substantial momentum abroad. Some of the important forfaiting centres are London, Zurich, Hongkong, Singapore and Frankfurt. In India, forfaiting business is slowly emerging as a new product in the liberalised financial market. The existing scheme available for exporters like concessional finance by Commercial banks, insurance cover against export credit risks by ECGC etc., are available mainly to large and well established exporters. In this context, forfaiting is a real boon to the small as well as new exporters.

In India, forfaiting is done by EXIM bank. The minimum value of forfaiting transactions is Rs. 5 Lakhs. An Indian exporter who wants to availe of this service has to approach the Exim Bank through his bank. The Exim Bank obtains the forfaiting quotation from the forfaiting agency abroad. Based on this, the exporter would work out his price to be quoted to the importer. If the importer accepts the price and the payment terms, the contract would be finalised and executed. The exporter would then get cash through forfaiting arrangements for which he has to enter into or separate contract with the forfaitor through the Exim Bank. In order to encourage forfaiting finance business, it is necessary to designate export contracts in international currencies. In the wake of economic liberalisation and opening of our country to the global market, there are good prospects for forfaiting business in India.

LEASING

Objectives :

- To understand the concept of Leasing
- To know different types of leasing
- To examine the advantages and disadvantages of leasing
- To identify the problems of leasing and its future prospects

Structure :

16.30 Introduction
16.31 Concept and Evolution
16.32 Development of Leasing
16.33 Types of Lease
16.34 Advantages of Lease
16.35 Disadvantages
16.36 Structure of Leasing Industry
16.37 Problems of Leasing
16.38 Future Prospects

16.30 INTRODUCTION :

Leasing as a method of financing equipment and machinery purchases has a competitive advantage and has been very well established in developed economies. It is note worthy that in developing countries like South Korea, Malasia and Indonesia, the leasing industry has grown dramatically, the annual growth rate ranging from 50% to 100%. Equipment leasing is relatively new in India. It has been estimated that currently an insignificant 1% of the total equipment purchases are financed through leasing. However, in the current Indian context, lease finance offers several advantages - a fact which is being increasingly realised by the financial industrial community in the country.

16.31 CONCEPT AND EVOLUTION :

Leasing as a financing concept, is an arrangement between two parties the leasing company or lessor and the user or lessee, where the former arranges to buy capital equipment for the case of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment. By reporting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost.

The practice of leasing evolved repidly in other developed countries in the 1970s as a convenient form of business financing. The rapid growth of equipment leasing business in UK is indicated by the figure of the Equipment Leasing Association (ELA), whose membership is dominated by big UK banks and which claims to account for atleast 90% of the market. In recent years, international leasing, to promote exports, has been on the increase in most of the recession ridden developed world and this trend is exepted to accelerate as users of such equipment in the developing world find this form of financing cost effective and attractive.

16.32 DEVELOPMENT OF LEASING :

Since world war - II the use of leasing has been greatly expanded and is constantly used for new products and new industries. In May 1952, Henry Scholfeld set up a separate corporation in USA to handle lease transaction. Since, 1963, commercial banks were allowed to engage themselves in direct leasing. The concept of financing leasing was pioneered in India during 1973. The First company was set up by Chidambaram group in 1973 in Madras. The company undertook Leasing of industrial equipment as its main activity. The Twentieth century Leasing Company Ltd., has established in 1979. By 1981, four finance companies joined the fray. Industrial Credit and Investment Corporation of India (ICICI) was the first All India Financial Institution to offer leasing in 1983. Entry of commercial banks into leasing was facilitated by an amendment of Banking Regulation Act 1949. State Bank of India was the first commercial bank to setup a leasing subsidiary,SBI capital market in October 1986. Can Ban Financial Services Ltd, BOB Financial Services Ltd, and PNB Financial Services Ltd followed suit. The Industrial Finance Corporation's Merchant Banking Division started financing leasing companies as well as equipment leasing and financial services. There was a

virtual explosion in the number of leasing companies in the country and the number roles to around 400.

In the subsequent years, the adverse trends in capital market and other factors led to a situation where apart from the institutional lessors, there were hardly 20 to 25 private leasing companies that were active in the field.

16.33 TYPES OF LEASE :

The lease agreement can be classified into the following categories.

1) Financial Lease :

A financial lease is also known as capital lease, long term lease and close lease. In a financial lease, the lessee selects the equipments, settles the price and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable and non cancellable contractual agreement with the leasing company. The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it. He also bears the risk of absolescence as it stands committed to pay the rental for the entire lease period.

Under the financial lease, the rate of lease or short would be fixed based on the kind of lease, the period lease, periodicity of rent payment and the rate of depreciation and other tax benefits available. The leasing company also charges nominal service charges to cover legal and other costs. The financial lease is very popular in Indian as in other countries like USA, UK and Japan. On an all India basis, at present, approximately a lease worth Rs. 75 to Rs. 100 crores is transacted as a tax planning device. The high cost of equipments such as office equipment, diesel generators, machines tools, textile machinery, containers, locomotives etc., are leased under financial lease.

2) Operating Lease :

An operating lease is also known as service lease or short term lease. In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment. This means that the lease is for a limited period, may be a month, six months, a year or few years. The lease is interminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. This lease is suitable for computers, copy machines and other office equipments, vehicles etc., which are sensitive to obsolescence.

3) Leverage Lease :

A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from Rs. 50 lakhs to Rs. 2 crores and has economic life of 10 years or more. The leverage lease agreement involves three parties, the lessee, the lessor and the lender. The lessor acquire the assets as per the terms of the lease agreement but finances only a part of the total investment say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. In leveraged lease, wide range of

equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc., are acquired.

4) Sale and Lease Back :

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to the asset during the lease period. The firm makes periodical rental payments to the lessor. The title to the asset vest with the lessor. The sale and lease back agreement is beneficial to both lessor and lessee. The lessee get immediate cash which becomes available for working capital for for further expansion and lessor gets tax benefits. Retail Stores, office buildings, shopping centres are financed under this method.

5) Cross Border Lease :

Cross Border lease is international leasing and is known as transnational leasing. It relates to a lease transaction between a lessor and lessee domiciled in different countries and includes export leasing. For example, if a leasing company in USA makes available an Air bus on lease to Air India, there would be a cross border lease.

6) Instalment Buying, Hire Purchase leasing :

In instalment buying, the property passes on the buyer immediately as soon as the first instalment is made, the balance amount is payable in instalments under this, the buyer has no right to return the goods. In case of default, the seller has the right to file a suit in the court of the law to recover his dues.

Hire purchase is an agreement under which the owner delivers the goods to the buyer who agrees to make periodical payment as hire charges. The possession of goods vest with hirer but the ownership remains with the seller. On full payments of hire charges, the buyer gets the option of purchasing the goods. On default, the seller can reclaim the goods, subject to certain rules.

In leasing, rental charges are debited to profit and loss account and the leased asset is not shown the balance sheet of the lease.

16.34 Advantages of Lease :

1) A major advantage in favour of leasing is that the transactions is ‘off the balance sheet’ financing. The lease contract need to be disclosed in the balance sheet of the lease.
2) Leasing permits the lessee to get the services of an equipment which he otherwise cannot acquire.
3) Leasing enables many companies to obtain the conservation of the credit limits for other purposes.
4) Leasing gets away with the risk of obsolescence to the lessor. This is attached to the lessor. Normally, leasing is preferable when the risk of absolescene is quite high in an asset.
5) Leasing may increase long term ability to acquire funds. The lessee can utilise more funds for working capital needs.

From the above, it can be seen that leasing is both a flexible and a convenient method of providing funds for the acquisition of the equipment by any business enterprise.

16.35 Disadvantages :

1) Lease is not suitable mode of project finance. This is because rentals are repayable soon after entering into lease agreement while in new projects cash generations may start only after a long gestation period.
2) Certain tax benefits / incentives such as subsidy may not be available on lease equipment.
3) The cost of financing is generally higher than that of debt financing
4) If the lessee is not able to pay rentals regularly, the lessor would suffer a loss particularly when the asset is a sophisticated one and less liquid.

16.36 STRUCTURE OF LEASING INDUSTRY :

The present structure of leasing industry in India consists of i) Private Sector Leasing ii) Public Sector Leasing.

1) Private Sector Leasing :

i) Pure Leasing Companies
ii) Hire Purchase and Finance Companies
iii) Subsidiaries of Manufacturing Group Companies

2) Public Sector Leasing :

i) Leasing divisions of financial institutions
ii) Subsidiaries of Public Sector Banks
iii) Other public sector leasing organisations.

16.37 PROBLEMS OF LEASING :

Leasing has great potential in India. However, leasing in India faces serious handicaps which may its growth in future which are given below :

- Unhealthy competition
- Lack of qualified personnel
- Burden of Tax considerations
- Stamp Duty for lease documents
- Delayed Payment and Bad Debts

16.38 FUTURE PROSPECTUS :

Leasing today accounts to for 6% of the total capital investment in India. Today nearly 300 odd companies which orginally started with leasing as their main activity, have become dormant or have gone into different fields of the nationalised banks into this field of activity, it is expected that the leasing business will pick up and grow as a commonly accepted method of funding for business entities. Demand wise the market for the leasing industry is quite bright and with the government and the RBI backing up this particular activity.

The world leasing industry grew at a rate of 10%. As the economy is opened up, there will be substantial demand for a variety of leasing products such as foreign currency leasses, leverage

leaser and cross border leases. Leasing is a threshold of a major break through in India's industrial development due to liberalised economic policy of the government. The infrastructure financing so crucial for economic growth cannot be accelerated without leasing industry.

VENTURE CAPITAL

Objectives :

- To understand the concept and meaning of Venture Capital
- To know the features and importance of venture capital
- To examine the stages of venture capital and development of venture capital business in India
- To offer suggestions for the growth of this business.

STRUCTURE :

16.39 Concept and Meaning
16.40 Features of Venture Capital
16.41 Stages of Venture Capital
16.42 Importance of Venture Capital
16.43 Development and Initiative in India
16.44 Venture Capital firms in India
16.45 Suggestion for the growth of Venture Capital funds

16.39 CONCEPT AND MEANING :

The term venture capital refers to the commitment of capital as share holding, for the formulation and setting up of small firms specialising in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. Venture capital is a long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pools his resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium. A Venture capital company in defined as 'a financing institution' which joins an entrepreneur as a copromoter in a project and shares the risks and rewards of the enterprise".

16.40 FEATURES OF VENTURE CAPITAL :

1) Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2) It is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
3) Investment is made not only in high risk but also in high growth potential projects.
4) Venture capatalist joins the entrepreneur as a copromoter in projects and share the risks and rewards of the enterprise.

5) Venture capital is not just injection of money but also an input needed to set up the firm, design its marketing strategy, organise and manage it.

6) Investment is usually made in small and medium scale enterprises.

16.41 STAGES OF VENTURE CAPITAL :

Venture capital may take various forms of different stages of the project. There are four successive stages of development of a project which are discussed below :

i) In the initial stage, venture capitalists provide seed capital for translating an idea into business proposition. At this stage, investigation is made indepth which normally takes a year or more.

ii) When the firm is setup to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

iii) On the third stage, the firm has made some head way and entered the stage of manufacturing a product and but faces teething problems. It may not be able to get generate adequate funds and so additional round of financing is provided to develop th marketing infrastructure.

iv) At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of establishment stage, the firm is listed on the stock exchange and at this point, the venture capatalist disinvests their shareholdings through available exists routes.

Before investing in small, new and young hitech enterprises, the venture capitalists, look for percentage of key success factors of a venture capital project. They prefer projects that address these problems. After assessing the viability of projects, investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation. All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks, invest in one or more. Hence, they specialise in one or more but rarely all.

16.42 IMPORTANCE OF VENTURE CAPITAL :

Venture capital is of great practical value to every corporate entreprise in modern times. A developed venture capital institutional set up reduces the time lag between a technological innovation and its commercial exploitation. It acts as a cushion to support business followings as bankers and investors will not lend money with inadequate margin of equity capital. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of the equity and debts. Therefore, the investors would be able to invest in new business through venture funds and it the same time, they can directly investor in existing business when venture fund disposes its own holding. This mechanism will help to channalise investment in new high tech business or the existing sick business. These business will take off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.,

The economy with well developed venture capital network induces the entry of large number of technocrafts in industry, helps in stabilising industries and in creating a new set of trained technocrafts to build and manage medium and large industries, resulting in faster industrial development. A venture capital firm serves as ain intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital. Besides, the investing public will be able to reduce risk significantly if the public invest in venture fund which in turn will invest in equity of new business.

16.43 DEVELOPMENT AND INITIATIVE IN INDIA :

Venture capital as a new phenomenon originated in USA and developed world wide since the second half of the seventies. Since then, the industry has developed in many other countries in Europe, North America and Asia. In USA alone there are 800 venture capital firms managing around $ 40 billion of capital. Some of the present day giants like Apple, Microsoft, etc., are the beneficiaries of venture capital. UK occupies a second place after US in terms of investment in venture capital. The concept became popular in late sixties in UK. During 1988, there were over 1000 venture capital companies in UK which provided Rs. 3700 crores to over 1500 crores.

The success of venture capital in these countries prompted India to design and implement measures to promote venture capital. Indian tradition of VC for industry goes back more than 150 years when many of the managing agency houses acted as venture capitalists providing both finance and management skill to risky projects. The totals initiated a managing agency system, named Investment corporation of India (ICI) in 1937 which by acting as venture capitalists successfully promoted hi-tech enterprises such as CEAT tyres. National Rayon etc., The early form of venture capital enabled the entrepreneurs to raise large amount of funds and yet retain management control. Venture capital's growth in India passed through various stages. In 1973, RS Bhatt Committee recommended Research Development Cess Act was enacted in 1886 which provides a Cess of 5% on all payments made for purchase of technology from abroad. Formalised venture capital took roots when venture capital guidelines were issued by the comptroller of capital issues in November 1988.

16.44 VENTURE CAPITAL FIRMS IN INDIA :

At present, several venture capital firms are incorporated in India and they are promoted by all India Financial Instititutions like IDBI, IFCI, ICICI, State level financial institutions, public sector banks etc., Venture capital players can be classified into the following four categories.

1) Companies promoted by all India financial institutions

- Risk capital and Technology Finance Corporation Ltd., (RCTC) promoted by IFCI
- Technology Development and Information Company of India Ltd (TDICI) Promoted by UTI, ICICI
- IDBI venture capital fund

2) Companies promoted by State Level financial institutions

- Gujarat Venture Finance Ltd (GVFL)
- Andhra Pradesh Industrial Development Corporation of Venture Capital Ltd (APIDCVC)

3) Companies promoted by Banks

- Can Bank venture capital fund (Promoted by canfin & Canara Bank)
- SBI venture capital Fund (promoted by SBI Caps)
- Indian Investment Fund (Promoted by Grindlays Bank)
- Infrastructure Leasing (Promoted by Central Bank of India)

a) Companies in Private Sector

- Indus Venture Capital Fund
- Credit Capital Venture Fund (India) Ltd.
- 20th Century Venture Capital Corporation Ltd.,
- Venture Capital Fund promoted by VB Desai & Co.

There are 20 venture capital companies in India both in Private and Public sectors. At the end of 1996, 14 members of Venture Capital Association of India had set up 17 funds. They had access to Rs. 1402 crores.

16.45 SUGGESTIONS FOR THE GROWTH OF VENTURE CAPITAL FUNDS :

Venture capital industry is at the take off stage in India. It can play a catalytic role in the development of entrepreneurship skill that remains unexploited among the young and energetic technocrafts and other professionally qualified talents. It can help promote new technology and hi-tech industries which involve high risk but promises attractive rate of return. In order to ensure success of venture capital in India, following suggestions are offered.

Today's need is to review the constraints under various laws of the country and resolve the issues that could come in way of growth of the innovative mode of financing. The inititative on the part of the government in the direction would see rapid growth of a new breed of venture capital assisted entrepreneurs. The benefit of capital gains is not significant. Hence, it is advisable that all long term capital gains earned by venture capital companies should be exempted from tax burden. Success of venture capital fund depends very much on profitable disinvestment of the capital contibuted by it. Stock markets provide excellent disinvestment mechanism for venture funds. Stock market operations may be started at many more cities in India and the number of stock exchanges can be increased to 50. All avenues are to be provided to private sector to promote venture capital business.

INSURANCE

STRUCTURE :

16.46 Introduction
16.47 Developments in Banking Sector
16.48 Banks in Insurance Business

16.46 INTRODUCTION :

The financial system occupies the centre stage in the new age of economic paradigm. Market mechanism is progressively becoming the order in the orderly development of an integrated financial

market. For banks, a major falls out of reforms could be traced to fierce competitive pressures, necessitating frequent startegic shifts in thier functions and operations. Public sector banks have been confronted with new challenges, which were unheard of in the Post Nationalisation period upto the nineties. Convergence by and large has emerged within the broad spectrum of financial instititutions and services mostly, in the forms of synergy based mergers, joint ventures and a host of strategic alliances between banks and non banks. It is in the context of such convergence that the mutual exclusively between banks and insurance majors is gradually disappearing.

Recent Developments in Insurance Sector :

Appointment of the RN Malhotra Committee in 1993-94 was a landmark in the history of Indian insurance sector. The committe's report has infused the requisite dynamism to the insurance majors in the form of greater role for market, entry of new players, product pricing, appropriate regulatory mechanism etc., The Insurance Regulatory Act was passed in 1999. The initiatives of the govt. have led to birth of new insurance players and intensification of competitive forces in the market.

Insurance is estimated to be Rs. 400 billion business in India. Clubbed with banking insurance accounts for more than 7% of India's growth domestic product. As a requel to the varied policy inititives, the state monopoly in insurance has been considerably diluted.

16.47 DEVELOPMENTS IN BANKING SECTOR :

April 2000 saw the first major step for bringing insurance lender bank's fold. The RBI issued guidelines as part of its monetary and credit policy, for banks to enter into insurance business. Later IRDA issued regulations on registration of insurance companies, followed by the govt, notification under which insurance business could be under taken by banks under the Banking Regulation Act 1949.

Following are the norms to be followed by banks :

- Net worth should not be less than Rs. 500 crores.
- Capital adequacy ratio should not be less than 10%.
- Level of non performing assets should be reasonable.
- Bank should have posted net profits for the last 3 years

As a result, many of banks started distribution of insurance products as corporate agents. Tie up with insurance majors enabled banks to repackage their products with lucrative add on facilities and to act as collecting / paying agents for premium collection and claim settlements. Bank assurance is one novel concept which is progressively gaining ground as part of a move over to the concept of universal banking.

16.48 BANKS IN INSURANCE BUSINESS :

One private sector bank was given approval for participating in insurance joint venture on risk participation basis. 13 private sector banks including foreign banks and one financial services company were given in principal the approval for acting as 'corporate agents' to undertake distribution of insurance products on agency basis without any risk participation. A few banks have been

permitted to enter into referral arrangements with insurance companies subject to certain conditions to protect the interests of their customers.

The liberalisation of the insurance sector is expected to enhance consumer choice through product innovation. The life insurance sector new offers money back options, Pension plans and unit linked insurance plans etc., The liberalisation impacts the functioning of the financial system through the linkage with the existing financial institutions and financial products. The RBI has given permission to five Non Banking Finance Companies (NBFCs) to undertake insurance business as joint venture participants in insurance companies. Further, the Insurance (Ammendment) Act 2002, allowed cooperative societies to carry on insurance business with a view to enhancing coverage in rural areas. The initial response to bank's entry into insurance has been quite encouraging. Banks need to put in place a definite plan of action in order to ensure sustainability in the growth impetus in insurance linked business. Banks have already been successful in making insurance a vital component of the Kisan Credit Card Scheme. They can infact gainfully contribute to the rural uplift and remain profitable by factoring in insurance into their service basket.

UNIVERSAL BANKING

STRUCTURE :

16.49 Introduction
16.50 Emerging Universal Banking
16.51 Scope for Research in Banking Industry
16.52 Personnel Research in Banks - Importance
16.53 Scope for Research in Banking
16.54 NIBM
16.55 IBA
16.56 IDRBT

16.49 INTRODUCTION :

Universal banking means provision of all financial services by a bank under one umbrella. In general, Universal Bank is a name given to banks engaged in diverse kind of banking business. According to one school of thought, there four different types of several banks in the world.

i) Fully Integrated Universal Bank :

One institutional entity offering the complete range of services.

ii) Partly integrated financial conglomerates :

One which offers range of services but some of the range (for example, mortgage banking, leasing and insurance) are provided through wholly owned or partially owned subsidiary.

iii) Bank Subsidiary Structure :

One which focuses on commercial banking and other functions, including investment banking and insurance, which are carried out through legally separate subsidiaries of the bank.

iv) Bank Holding Company Structure :

One financial holding company owns both banking and non banking subsidiaries that are legally separate and individually capitalised in so far as financial services other than banking are permitted by law.

Generally the concept of universal banks is based on two financial models. One is German type in which the big banks carry comprehensive banking activitites including commercial banking as well as other services such as securities related services and insurance. The other British - American type in which specialised banks, in accordance with change of financial environment, pursue diversification in securities and investments.

16.50 EMERGING UNIVERSAL BANKING :

With introduction of deregualation in most of the developed countries in 1980's and the increasing disintermediation in both the domestic and international capital markets, the banks became very vulnerable to interest income i.e., intermediation income. Due to this, banks started placing more emphasis on new sources of non interest income. This led to the diversification in activities in financial sector undertaken by the existing as well as new players. Some of these players later came to be known as universal banks and their activities and operations are as follows :

- Practice of making loans and advances on a longer term
- Internationalisation in domestic and international financial markets through new financial innovations
- Underwriting new debt and equity issues
- Venture capital of Insurance
- Brokerage
- Corporate advisory services, including mergers and acquisitions advice
- Holding equity of non financial firms in the bank's portfolio.

In a nutshell, the features of universal banks depends on country's diversification rules and the strengths of individual banks in enlarging the scope of activities in the various segments of financial sector. The recommendations of Narasimham and Khan committees would encourage evolution of universal banking. Indian banks are moving in the direction of universal banking i.e., undertaking all financial services under one cover.

16.51 SCOPE FOR RESEARCH IN BANKING INDUSTRY :

Research in Banks :

Research in banks is considered synonymous with economic research to help the banking sector interpret economic trends and accordingly project their business. The kind of human problems that are emerging in banking and the solutions that research can suggest are strong arguments for managers to develop faith in research. Personnel management in banks consines to be traditional ignoring the need for research on the enormously complex problems of human behaviour.

16.52 PERSONNEL RESEARCH IN BANKS - IMPORTANCE :

According to Jucius "Personnel Research is the task of sorting for and analysing facts to the end that personnel problems may be solved or that guidelines giving their solutions may be deducted " following are the main areas of personnel research in banking industry.

i) to measure and evaluate present conditions
ii) to project future conditions, events and behavioural patterns
iii) to evaluate the facts and results of current policies, programmes and activities
iv) to provide an objective basis for revising current policies programmes
v) to appraise proposed policies & programmes

Personnel research in banks is a highly skilled profession. It demands ability to identify the problem and to analyse data to arrive at correct conclusion so as to make a specific recommendation for action. Personneal research is of little value of managers unless they lead to some creative changes, when the data suggests that something is wrong, The data supplied by personnel research points to the need for preventive and remedial action. It is here that management is expected to use this data for better decision making.

16.53 SCOPE FOR RESEARCH IN BANKING :

Some of the crucial areas which provide the scope for research in banking industry are given hereunder.

Most of the following in the personnel area are conflict problems arising out of leadership tussle between the union leader and the branch manager, inter union rivarises, and hoc decision making etc., Bargaining with the employee's is done without researching into the problems and in the absence of concrete data the management is not able to discuss its own problems with 'the employee unions. Research in this area can reveal reasons for some of the puzzling questions like. Why people do not work ? why certain branches are problem branches ? Why managers heritage in initiating disciplinary action ? Why overtime is uncontrollable ? what kind of grievances are arising in the organisation and why ? What are employees aspirations on the job ? etc.,

This type of research is very delicate and crucial for decision making. Therefore, management should be open enough to permit it. This is newly emerging area and can give significant information to management about the organisational climate, employee attitude, job satisfaction, a morale, managerial styles, communication channels etc., and development of personnel systems based on the findings of the research and it can significantly help in better management of human resources.

Banks should find out through research studies as to what strategies should be derived to develop people and prepared them for higher responsibilities. There are other vital areas in personnel management which need to be researched i.e., placement policies, transfer policies, promotion policies etc., In recent times, there is lot of scope to carry out research in the banking industry with regard to the introduction of new and innovative deposit schemes, loan schemes to cater different clients, new financial products, ways and means to diversity the financial acitivities of banks, schemes on expansion of business, policies on professional banking and methods to compete and stand in the financial market etc., Research could be carried out on these areas by the individual banks. Almost all banks and financial institutions have their exclusive research and development divisions located at their headquarters with all necessary staff and infrastructure to carryout research programmes on various aspects of current importance.

16.54 NIBM :

National Institute of Bank Management (NIBM) was set up in 1968 at Pune, mainly to organise training, research and consultancy for the banking industry. NIBM has made commendable efforts in helping bank managements to install training systems in their respective banks are has also rendered to some banks in the area of reorganisation and reconstruction etc, In 1979, NIBM organised a progaramme on 'Research Methodology for personnel management', with the objective of creating a cadse of personnel researchers in banks.

16.55 IBA :

The industry level negotiasions in the matter of wages and service conditions for the staff are undertaken by Indian Banks Association (IBA) on behalf of managent of banks. As an apex oganisation of banks, IBA personnel department should have full fledged research wing with compenant research staff so that research studies can be undertaken on various crucial matters of banking sector. The IBA can undertake researches in the wage patternvuus of employees in other sectors as also on the implementation of various matters covered under bipartite settlements.

Now the banks have been recruising high talented and qualified personnel at all the levels with bent towards research, it would be desirable it suitable research projects on the problems of the banks in different areas can be assigned to them. Some of the officer's who aspire to do their Ph.D. work can also be given the problems of the banks. Banks can also establish liasion with the expert faculty of institutes of management and universities and can get their problems investigated into.

16.56 IDRBT (Institute for Development and Research in Banking Technology)

The IDRBT was set up by the Reserve Bank of India in 1996 at Hyderabad with an objective of making the institute a think bank for the promotion of technology solutions to improve the functioning of the banking and financial sector. With a view to provide guidance to banks in networking and security issues in applications, IDRBT has taken up research programmes in Electronic payment systems, security standards, certification, data warehousing, multi-media products etc., The institute is also actively associated with a number of activities co-ordinated by the RBI and Indian Banks Association (IBA) on the areas of technology upgradation in banking sector, payment systems and inter bank applications.

The purpose of research in banking sector is to streamline and develop appropriate technologies and innovations that can serve better the requirements of the growing industry. The RBI through the department of Economic Analysis and policy and the Department of Statistical Analysis and Computer services has been over the years collecting and analysing useful information and data on banking, industry, agriculture and other related matters and disseminating to the wider public. The NIBM does a number of research projects on various aspects of banking. The Indian Bank's Association (IBA) and Indian Institute of Banker (IIB) have been playing a useful role in helping the banks to carryout research work on banking.

16.57 KEY WORDS :

1. Virtual Banking :

It would mean any banking services delivered to the customer by means of a computer contolled system that does not directly involve the usual banks branch. ATM's, Internet and smart cards are examples of virtual banking.

2) Credit Syndicasion :

A Syndicated credit is an agreement between two or more lending institutions to provide a borrower a credit facility using common loan documentation.

3) Securitisation :

It is a process by which the forecast future income of an entity is transformed and sold as debt instruments such as bonds, with a fixed rate of return.

4) Universal Banking :

It means provision of all financial services by a bank under one roof. For example, loans to industries, Venture capital, underwriting, brokerage, corporate advisory services, merchant banking and insurance etc.

16.58 SELF - ASSESSMENT QUESTIONS :

1) What are the causes for diversification of financial service / activities by Commercial Banks
2) Define Merchant Banking ? Explain the services provided by Merchant Banks ?
3) Discuss the qualities of Merchant Bankers and Examine the Scope of Merchant Banking in India?
4) Explain the Concept, Objectives, Merits and Short comings of Mutual Funds ?
5) What are the types of Mutual funds ?
6) Discuss the importance of Mutual Funds and explain how Mutual Fund industry is operating in India ?
7) Describe the concept and functions of Factoring ?
8) Explain the types of factoring and examine briefly on the working of factoring in India ?
9) Define forfaiting and explain the benefits and drawbacks of forfaiting ?
10) Briefly outline th progress of forfaiting in India ?
11) Explain the concept of leasing and explain the types of lease ?
12) What are the advantages and disadvantages in Leasing business ?
13) What is venture capital ? Explain the features and stages of venture capital ?
14) Discuss the importance of venture capital and Examine on how venture capital business is developing in India ?
15) Explain the recent developments in Insurance sector and discuss on the progress of banks entering into insurance business ?
16) Write a Note of Universal Banking ?
17) Outline the importance of Research in Banks and discuss onthe scope of Research in Banking?