Lesson – 1

TYPES OF BANKS

11.0 OBJECTIVES

After going through this lesson student can know

- Banking – origin and Growth
- Types of Bank
- Nature and Trends in Banking

Structure

1.1 Introduction
1.2 Meaning and Definition of Banking
1.3 Growth of Bank in India
1.4 Kinds of Banks
1.5 Commercial Bank – Functions
1.6 Trends in Commercial Banking
1.7 Terminology
1.8 Self Assessment Questions
1.9 Reference Books

1.1 INTRODUCTION

The origin of banking can be traceable in the early times of human history. In the ancient Rome and Greece, the practice of storing precious metals and coins at safe places and loaning out money for public and private purposes on interest was prevalent. In India, the reference to money lending business are found in the ‘Manu Smrite’. The origin of banking lies in the business of money changing in ancient days. The emergence of banks in the early period was the need for borrowing by the monarchial governments from finance companies. In the middle ages, in Italy the first public enterprise bank called the ‘Bank of Venice’ was established in 1157.

History shows the existence of a ‘Monte’ in Florence in 1336. Monte means – a standing bank or amount of money. The word ‘Bank’ is derived from the Greek word ‘banque’ or the Italian word ‘Banco’, means a bench. Bench is a place at which money lenders and money charger used to display their coins and transact the business. Modern banking business was first started in 1349 in Barcelona. In 1407 Bank of Genoa, in 1609 Bank of Amsterdam were established.

In England, initially The Bank of England was established in 1694 on Italian lines to support the government with finance. Modern Joint-stock commercial Banks came into existence with the passage of Banking Act of 1833 in England.

In India, modern banking started when the English agency houses in Calcutta and Bomaby began to serve as bankers to East India Company. The Hindustan bank was the first banking institution of its kind, established in 1779.

According to Crowther, modern banking has three ancestors. (1) the merchant (2) the goldsmith (3) the money lender.

(1) The Merchant : The Merchant banker forms the ealiest stage in the evolution of modern banking. Trading activities require remittances of money from one place to another. Because of possibility of theft of metallic money during transportation, traders issued a documents like hundi or letter of transfer to remit the funds. Moden banks remit.

(2) The Goldsmith : The goldsmith ancestry of the modern banks is purely an English affair. Since goldsmiths dealt with precious metals, they necessarily provided secure safe to protect them. In a period when money consisted of gold and silver, because of the danger of theft, people started leaving their precious bullion and coins in the custody of goldsmiths. As the practice of safe-guarding others' money became widespread the goldsmiths began imposing charges for the safe keeping service.

(3) The Money Lender : The goldsmiths soon realised that daily withdrawals were equal to daily deposits and only a contingency reserve was required for the periods when withdrawals exceeded deposits. After keeping this reserve, the goldsmiths loaned out the remaining deposits on interest. Thus, the money lender performing two functions of a bank i.e., accepting deposits and advancing loans.

Crowther says "The progeny of money-lender are concerned with flat money, piled up money, savings. The progeny of goldsmith are concerned with round money, circulating money, cash. The modern bank performs both the functions.

1.2 MEANING AND DEFINITION OF A BANK

A bank is an institution which deals with money and credit. It accepts deposits and make the funds available to those who need them, and helps in the remittance of money from one place to another.

The banking system constitutes the core of the financial sector. It plays a significant role in the process of economic growth of the country. Its efficiency and development are vital for the country's economic progress. Banks play an important role in the organised sector of the Indian money market. They are the major source of institutional finance in the country. Now-a-days Modern Banks perform a variety of functions. Hence it is difficult to define bank and banking. Due to this reason, different economists define bank differently.

According to crowther, a bank "collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it".

In the words of Kinley, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use".

According to John Paget, Nobody can be a banker who does not (1) take deposit accounts (2) take current accounts, (3) issue and pay cheques and (4) collects cheques – crossed and uncrossed for its customers".

R.S.Sayers defines the term a bank as "an institution whose debts are widely accepted in settlement of other people's debts to each other".

According to the Indian Banking Regulation Act, 1949, banking means "the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise".

In short, the term bank in the modern times refers to an institution having the following features.

1 It deals with money, it accepts deposits and advances loans.
2 It also deals with credit, it has the ability to create credit i.e., the ability to expand its liabilities as a multiple of its reserves.
3 It is commercial institution, it aims at earning profit.
4 It is unique financial institution that creates demand deposits which serve as a medium of exchange and as a result, the banks manage the payment system of the country.

1.3 GROWTH OF BANK IN INDIA

A well developed banking system is a necessary pre-condition for economic development in a modern economy. Indian Joint Banks are those banking companies registered in India under the Indian Companies Act and also subject to the Indian Banking Regulation Act, 1949. They are essentially commercial banks operating in western style. They render banking services, such as acceptance of deposits, advancing loans and remittance facilities.

The origin of modern banking in India was established in 1770, named the Hindustan Bank. But the bank was wound up in 1832.

The real growth of modern commercial banking began in the country when the government was demanded to the need for banks in 1806 for the establishment of the first Presidency Bank, known as the Bank of Bengal in Calcutta. Two other Presidency Banks were established as the Bank of Bombay in 1840 and the Bank of Madras in 1843. These banks enjoyed the monopoly of the government banking. They were also given the right of note issue in 1823, which was withdrawn in 1862. They were worked till 1920. In 1921 they were amalgamated into the Imperial Bank of India. Later it was nationalised in 1955 and known as State bank of India.

Indian Joint Stock Banks

Since 1860 till the end of nineteenth century, a number of Indian Joint Stock Banks came into existence. For example, the Allahabad Bank was started in 1865 at Allahabad. In 1875 the Alliance Bank of Simla was started. In 1895, the Punjab National bank came into existence.

Several Indian entrepreneurs entered into the modern banking business. During the boom period of 1906-13, many prominent banks came into existence. There were the Bank of India (1906), The Canara Bank (1906), The Bank of Baroda (1908) and the Central Bank of India (1911).

The Indian Joint Sock Banks experienced several set backs during 1913-17. Most of the banks in India were failed during 1913-1939. The reasons are low capital, in experienced management, no central bank in the country etc. With the growing many of them could not survive. The rate of establishment and failure are high until the Banking Regulation Act, 1949 was passed.

1.4 KINDS OF BANKS

Financial requirements in a modern economy are of diverse nature, distinctive variety and large magnitude. Hence different types of banks have been established to cater to the varying needs of the community. Bank in the organised sector may be classified as :

1. Central Banks
2. Commercial Banks
3. Specialised Banks
4. Co-operative Banks

1. CENTRAL BANKS

A central bank is the apex financial institution in the banking and financial system of the country. It acts as a leader of the money market. It supervises, controls and regulates the activities of the Commercial banks. It is a service oriented financial institution primarily related with the ordering, supervising regulating and development of the banking system in the country. It can influence monetary and credit Conditions and financial developments in a country. It has the responsibility of carrying out the monetary and credit policies.

India's central bank is Reserve Bank of India, established in 1935 as a shareholders' organisation. It was nationalized in 1949.

FUNCTIONS OF A CENTRAL BANK

It is difficult to lay down the hard and fast rules regard the functions of Cenral bank. The most important function of central bank is that it is a bank of issue. And the central banks perform the functions for the welfare of public and for the development of country. Its functioning is different from that of the Commercial bank. The functions of a central bank are of a very special character calling for skill, experience and judgement. Traditionally the central bank performs the function of monetary management. But now-a-day the changing objectives of the central bank aim at the development of the country. Following are the functions of central bank.

(1) note issue
(2) banker, agent and advisor of the Government
(3) Bankers' bank
(4) Custodian of cash reserves
(5) Custodian of Foreign exchange Reserves.
(6) Controller of Credit created by banks
(7) Implementing the Government monetary policy.

2. COMMERCIAL BANKS

These banks perform all kinds of banking business and generally finance trade and commerce. Their deposits are for a short period. These banks normally advances short-term loans to the businessmen and traders and avoid medium-term and long-term lending. However the commercial banks have extended their areas of operations to the medium term and long term finance. Majority of the commercial banks are in the public sector. But there are certain private sector banks operating as joint stock companies. Hence, the commercial banks are also called as joint stock banks.

FUNCTIONS OF COMMERCIAL BANKS

In modern world, banks perform a variety of functions. They are (1) Primary Functions, (2) Secondary Functions.

I. PRIMARY FUNCTIONS

A) Accepting Deposits : Banks accept deposits from the public to attract savings from all classes of individuals, banks maintain different types of accounts.

a) Fixed Deposit Accounts

b) Current Deposit Accounts

c) Savings Deposit Accounts

d) Recurring Deposit Accounts

e) Special Deposit Accounts

B) Advancing Loans : After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. Various types of loans granted by the banks are

a) Money at call and short notice

b) Cash Credit

c) Overdraft

d) Discounting bills of exchange

e) Term loans

f) Credit Creation

g) Promoting Cheque System

II. SECONDARY FUNCTIONS

A) Agency Functions : Banks also perform certain agency functions on behalf of their customers

a) Remittance of funds

b) Collection and Payment of Credit instruments

c) Execution of standing orders.

d) Purchasing and Sale of securities

e) Collection of dividends on shares

f) Acts as a trustee and executor

g) Acts as a representative and correspondent etc.

B) General Utility Services : In addition to agency services, the modern banks provide many general utility services as given below :

1) Locker facility

2) Travellers' Cheques

3) Letter of Credit

4) Collection of Statistics

5) Underwriting Securities

6) Gift Cheques

7) Acts as a referee

8) Foreign exchange business.

3. INDUSTRIAL BANKS

Industrial banks are also known as investment banks, mainly meet the medium-term and long-term financial needs of industries. In India, Indian Financial Corporation of India, State finance Corporation etc are playing significant role in the industrial development.

FUNCTIONS OF INDUSTRIAL BANKS

(1) Accepts long term deposits.

(2) Grant long term loans to purchase land, machinery, equipment etc.

(3) Sell or underwrite the shares and debentures of the industrial firm.

(4) Provides information regarding general economic position of the economy.

4. AGRICULTURAL BANKS

Agriculture requires both short-term and long term capital. Short-term capital is necessary to buy the seed and to meet the transplantation expenses. Long-term finance is needed to buy land and to make improvement. As a result the cooperative movement was started in India. The history of Indian cooperative banking was started with the passing of cooperative societies Act in 1904. Later many amendments were made and many acts were passed. AS a result three-tier structure of cooperative banking system established in India. They are

(1) Primary Co-operative Banks or Primary Agricultural Credit Societies : In rural areas there are primary cooperative banks provide short-term and medium-term credit needs of the farmers. It accepts deposits, grants loans and collects repayments. It acts as link between the borrowers one hand and the other cooperative banks and the Reserve Bank, on the other hand.

(2) District Cooperative Banks : These cooperatives are in the middle of the three-tier structure. The main function of this bank is to provide loans to primary cooperative societies. However, loans are also given to individuals and others.

(3) State Co-operative Banks : They are the apex in the three-tier structure, operating at the state level. The main function of state cooperative banks is to finance, control and supervise the district cooperative banks and through them, the primary banks.

5. EXCHANGE BANKS

Exchange banks finance foreign trade. They specialise foreign exchange business. They do have branches in important ports of the world.

FUNCTIONS OF EXCHANGE BANKS

(1) Collects information regarding importers and exporters.

(2) accepts and discounts foreign bills.

(3) issues letter of credit.

6. SAVINGS BANKS

The main purpose of saving bank is to promote saving habits among general public. In India, postal saving banks do this job.

FUNCTIONS OF SAVING BANKS

(1) Promotes saving habit of the public.

(2) Issues postal cash certificates

CLASSIFICATION ON THE BASIS OF OWNERSHIP

On he basis of ownership, banks can be classified as :

(1) **Public Sector Banks** : These are owned and controlled by the government. In India, the nationalised banks and the regional rural banks come under this category.

(2) **Private Sector Banks** : These banks are owned by the private individuals or corporations and not by the government or cooperative societies.

(3) **Co-operative Banks** : Co-operative banks are operated on the co-operative lines. In India, Co-operative credit institutions the organised under the co-operative societies law and play an important role in meeting financial needs in the rural areas.

CLASSIFICATION ON THE BASIS OF DOMICILE

On the basis of domicile bank are divided as :

(1) **Domestic Banks** : These are registered and incorporated with in the counry.

(2) **Foreign Banks** : These are foreign in orgin and have their head offices in the country of origin.

Scheduled and Non-Scheduled Banks

In India, banks have been broadly classified into Scheduled and Non-Scheduled banks. A Scheduled bank is one which has been included in second schedule of the Reserve Bank of India Act, 1934 and fulfils the three conditions (1) It has paid-up capital and reserves of at least Rs.5 lakhs. (2) It ensures the Reserve Bank that its operations are not detrimental to the interest of the depositors. (3) It is a corporation or a co-operative society and not a partnership or a single owner firm.

The banks which are not included in the second schedule of the Reserve Bank of India are non-scheduled banks.

1.4 COMMERCIAL BANK – FUNCTIONS

In The modern world, banks peform a variety of functions that it is not possible to listout all of their functions and services. However, some basic functions performed by the banks are discussed below.

I. PRIMARY FUNCTIONS

1. ACCEPTING DEPOSITS

The first important function of a bank is to accept deposits from those who can save but cannot profitably utilise those saving by themselves. People consider it more rational to deposit their savings in a bank because by doing so they earn interest on one hand and avoid the danger of theft on the other. To attract and promote savings from all sorts of individuals, the banks maintain different types of accounts.

(a) Fixed Deposit Account : In these account customer deposits money for a fixed period of time say one, two or five years etc and cannot withdraw before the expiry of that period. The rate of interest on this account is higher than that on other types of deposits. The longer the period, the higher will be he rate of interest. Fixed deposits are also called time deposits or time liabilities.

(b) Current Deposit Account : These accounts are generally maintained by the traders and businessmen who have to make a number of payments everyday. Money can be withdrawn as many times and in as much amount as desired by the depositors. Generally, no interest is paid on these accounts. And the deposits have to pay certain incidental charges to the bank for the services rendered by it. These are also called demand deposits or demand liabilities.

(c) Saving Deposit Account : The aim of these accounts is to encourage and mobilise small savings of the public certain restrictions are imposed on the depositors regarding the number of withdrawals and the amount to be withdrawn in a given period. Cheque facility is provided to the depositors. Rate of interest paid on these deposits is low as compared to that on fixed deposits.

(d) Recurring Deposit Account : The purpose of these accounts is to encourage regular savings by the public, particularly by the fixed income group. Generally money in these accounts is deposited in monthly instalments for a fixed period and is repaid to the depositors along with interest on maturity. The rate of interest on these deposits is nearly the same as on fixed deposits.

(e) Home Safe Accounts : This scheme aiming at promoting saving habit of the people. Under the scheme a safe is supplied to the depositor to keep it at home and to put his small savings in it. Periodically, the safe is taken to the bank where the amount of safe credited to his account.

2. ADVANCING OF LOANS

The second important function of a bank is advancing of loans to the public. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. Before advancing of loans, the banks satisfy themselves about the creditworthiness of the borrowers. Various types of loans granted by the banks are :

(a) Money at call : Such loans are very short period loans and can be called back by the bank at a very short notice of say one day to fourteen days. These loans are given to other banks or financial institutions.

(b) Cash Credit : It is a type of loan which is given to the borrowers against his current assets, such as shares, stocks, bonds etc. Such loans are not based on personal security. The bank opens the account in the name of the borrowers and allows him to withdraw borrowed money from time to time upto a certain limit as determined by the value of his current assets. Interest is charged not only on this amount actually withdrawn from the account.

(c) Overdraft : The bank provides overdraft facilities to its customers in times of need i.e., customers are allowed to withdraw more than their deposits. Interest is charged from the customers from the overdrawn amount.

(d) Discounting of bills of exchange : This is another type of lending by the modern banks. Through this method, a holder of a bill of exchange can get it discounted by the bank. In a bill of exchange, the debtor accepts the bill drawn upon him by the creditor, who is the holder of the bill, and agrees to pay the amount mentioned on maturity. After making some marginal deductions in the form of commission, the bank pays the value of the bill to the holder. When the bill of exchange matures, the bank gets its payment from the party which had accepted the bill. Thus, such a loan is self-liquidating.

(e) Term Loans : The banks have also started advancing medium term and long-term loans. The maturity period for such loans is more than one year. The amount sanctioned is either paid or credited to the amount of the borrower. The interest is charged on the entire amount of the loan and the loan is repaid either on maturity or in instalments.

3. CREDIT CREATION

Credit creation is a unique function of the bank. Credit creation is the outcome of the process of advancing loan as adopted by the banks when a bank sanctions a loan t its customer, it does not lend cash but opens an account in the borrowers' name credits the amount of loan to that account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation which results in an increase in the stock of money of the economy. Banks have the ability to create credit many more times than their deposits and this ability of multiple credit creation depends upon the cash reserve ratio of the banks.

4.PROMOTING CHEQUE SYSTEM

Banks provide a very useful medium of exchange in the form of cheques. Cheque is the most development credit instrument in money market. Through a cheque, the depositor directs the banker to make payment of the cheque to the payee. In modern business transactions, cheques have become much more convenient method of setting debts than the use of cash.

5. AGENCY FUNCTIONS

Banks perform certain agency functions for and on behalf of their customers.

(a) Remittance of funds : Banks help their customers in transferring funds from one place to another through cheques, drafts etc.

(b) Collection and payment of credit instruments : Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc.

(c) Execution of standing orders : Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia, etc., on behalf of their customers.

(d) Purchasing and sale of securities : Banks undertake purchase and sale of various securities like shares, stocks, bonds, debentures etc on behalf of their customers. Banks neither give any advice to their customers regarding these investments nor levy any charge on them for their service, but simply perform the function of a broker.

(e) Collection of dividends on shares : Banks collect dividends, interest on shares and debentures of their customers.

(f) Income Tax Consultancy : Banks appoint income tax experts to prepare income-tax returns for their customers and to help hem to get refund of income-tax.

(g) Acting as trustee and executor : Banks preserve the wills of their customers ad execute them after their death.

(h) Acting as representative and Correspondent : Sometimes the banks act as representatives and correspondents of their customers. They get passports, traveller's tickets, book vehicles, plots for their customers and receive letters on their behalf.

6. GENERAL UTILITY SERVICES

In addition to agency services, the modern banks provide many general utility services as given below :

(a) Locker Facility : Banks provide locker facility to their customer. The customer can keep their valuables and important documents in the lockers for safe custody.

(b) Traveller's Cheques : Banks issue traveller's cheques to help the customers to travel without the fear of theft or loss of money with this facility, the customers need not take the risk of carrying cash with them during their travels.

(c) Letter of Credit: Banks issue letters of credit to their customers certifying their creditworthiness. Letters of credit are very useful in foreign trade.

(d) Collection of Statistics : Banks collect statistics giving important information relating to industry, trade and Commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.

(e) Underwriting Securities : Banks underwrite the securities issued by the government, public or private bodies. Because of its full faith in banks, the public will not hesitate in buying securities carrying the signatures of a bank.

(f) Gift Cheques : Some banks issue cheques of various denominations (say of Rs.11,21,31,51,101, etc) to be used on auspicious occasions.

(g) Acting as Referee : Banks may be referred for seeking information regarding the financial position, business reputation and respectability of the customers.

(h) Foreign Exchange Business : Banks also deal in the business of Foreign currencies. And they may finance foreign trade by rediscounting foreign bill of exchange.

1.6 TRENDS IN COMMERCIAL BANKING

After independence, the emergence of planning in the country has provided direction and purpose to the commercial banks. A number of changes have taken place in the structure and functioning of Indian banking system. Important among them are :

1. **Branch Expansion**: A noteable feature of the branch expansion has been significant increase in the rural branches of the banks, particularly after the nationalisation of major banks in 1969. There were 299 banks and their branches were 65,340 at the end 2000. Nearly 60% of branches were scattered in rural areas.

2. **Deposit Mobilisation** : Commercial banks in India have played an important role in mobilising deposits of the people. Total deposits of scheduled banks have increased from Rs.908 crore at the end of 1951. to Rs.8,10,070 crores at the end of 2000. The deposits in the rural areas have increased more rapidly than in urban and semi-urban areas. The increase in deposits have been mainly due to economic development deficit financing, increased currency and expansion of banking facilities in the country.

3. **Credit Expansion** : The credit facility provided by commercial banks, has been increasing significantly year after year. Total advances of the scheduled banks increased from Rs.547 crores in 1951 to Rs.3599 crore in 1969 and further to Rs.4,21,479 crores in 2000. Banks provided loan facilities especially to agriculture, small scale industries and other priority sectors.

4. **Lead Bank Scheme**: The lead bank scheme was introduced by he Reserve Bank of India towards the end of 1969 with the objective of enabling the commercial banks to assume the

role of leadership for the development of banking and credit facilities throughout the country on the basis of area approach. Under this scheme, all the districts in the country have been allotted to the State Bank group, nationalised banks and private Indian banks. A lead bank is assigned the role of a catalytic agent of economic development through the expansion of bank branches and diversification of credit facilities in the districts allotted to it.

The main objectives of a lead bank are :

(1) to open branches in all the important localities of lead districts.

(2) to expand maximum credit facilities for development in the district.

(3) to mobilise the savings of the people in the district.

(4) to co-ordinate the activities of co-operative banks commercial banks and other financial institutions in the district.

FUNCTIONS

Following are the functions of lead bank scheme.

(1) to survey for the resources and potential for banking development in the district.

(2) to survey of industrial and commercial units and other establishments which do not have banking accounts.

(3) to examine the facilities for marketing of agricultural produce and industrial production storage and warehousing facilities and linkage of credit with marketing in the districts.

(4) to survey the required facilities for storing of fertilisers ad maintaining agricultural inputs and equipment in good condition.

(5) to recruit the trained staff to advise, to follow-up and to inspect the end use of loans granted to small borrowers and farmers.

(6) to assist the primary lending policies.

(7) to maintain contacts and relations with government and semi-government agencies.

5. **Increase in Small Customers** : The banking services were shifted from big consumers to small customers. Banking system is becoming more and more popular among the common people of the country. About 60 percent of depositors of commercial banks are saving depositors mainly from low and middle income groups. Recently, there is a considerable increase in saving bank accounts also special schemes such as differential rate of interest schemes have been introduced in 1972 to provide concessional credit to the economically and socially backward people to encourage the productive activities. Now-a-days banks show more concentration on financing the small farmers, artisans and small business firms.

6. **Development-oriented Banking** : Initially, Indian banks were mainly concerned with growth of commerce and some of the traditional industries such as cotton textiles and jute. The banks were concentrated in the big commercial centres and mostly short-term commercial loans were granted. After independence, banking in India has adopted the policies which are helpful for the development of the country. Now, the banks are providing medium tem and long-term loans and cater the needs of the agricultural and industrial sectors.

7. **Regulation by the Reserve Bank** : The Banking Regulation Act, 1949 and its subsequent amendments have given adequate powers to the Reserve Bank of India to control and regulate the banking system of the country. Effective measures of Reserve bank has resulted in

(1) the protection of the interests of the depositors.

(2) increase in the public confidence on banks.

(3) controlling the frequent failures of the banks.

(4) development of banks on sound lines and in proper direction.

8. **Advances to Priority Sectors** : An important change after the nationalisation of banks is the expansion of advances to the priority sectors. One of he objectives of nationalisation of banks was to extend credit to the borrowers of neglected sectors of economy. To achieve this objectives, the banks formulated various schemes to provide credit to small borrowers in priority sectors like agriculture, small scale business, transport, retail trade etc. The total credit provided by the banks in 1969 was Rs.504 crores. It was increased Rs.1,35,923 crores in 2000. In 1969 the loans granted to priority sectors was 12% of the total loans and it was increased to 42% at the end of 2000.

9. **Rural Development** : Recently banks have recognised the social objectives and worked for rural development and for removal of poverty. In 1978, Government of India launched Integrated Rural Development Programme for removing imbalances in rural economy and for all round progress of the rural areas. Under this programme, banks extended their services through various schemes. The programme has shown a notable progress in improving the standard of living of rural people

10. **Innovative Banking** : Recently, the Indian banks have introduced a number of innovations and diversifications in their operations to improve their performance. They are :

(1) adopting participatory approach

(2) adopting consortium approach in lending

(3) provision of single window lending.

(4) introducing credit card facility.

(5) introducing new technology, mechanisation and computerisation in lending operations.

(6) entering into related activities such as merchant banking, mutual funds, hire-purchase finance etc.

(7) paying more attention to consolidation, sophistication, better consumer service and greater profitability.

11. **Merchant Banking** : on account of their special knowledge of the financial needs of the traders, the merchant banks started the practice of accepting or guaranteeing the bills of exchange. The primary activity of merchant banks is providing financial services and guaranteeing sales and distribution of securities. They handle all aspects of the sale of industrial securities i.e., their origination, underwriting and distribution. They provide the services such as project promotion services, syndication of credit and other facilities project leasing, corporate advisory services, management of and dealing in commercial papers.

In recent years, particularly after nationalisation, commercial banking in India has been experiencing radical changes both quantitatively and qualitatively. The banking industry has grown geographically over the length and breadth of the country. The deposits and credit of the banks have multiplied. The banks have also taken the new responsibilities of serving the national plans and priorities for economic development.

1.6 TERMINOLOGY

Bank : A bank is an institution which deals with money and credit.

Scheduled Banks : A bank which is included in the second schedule of Reserve Bank of India Act, 1934 and fulfils the necessary conditions.

Non-scheduled Banks : A bank which is not included in the second schedule of the Reserve Bank of India Act.

1.7 Self Assessment Questions

5 Marks Questions

1. Types of Deposits

2. Money at call and short notice.

3. Agricultural Banks

4. Exchange Banks.

5. Industrial Banks.

6. Merchant Banking.

10 Marks Questions

1. What are different kinds of Banks.

2. Discuss the ‘Lead Bank Scheme’.

20 Marks Questions

1. Explain the functions of Commercial banks.

2. What are Trends in Banking.

3. Explain the origin and growth of banking.

1.8 REFERENCE BOOKS

Banking and Financial System	A.V.Ranganadha Chary & R.R.Paul
Banking and Financial Services	S.N.Maheswari & R.R.Paul
Banking and Financial Systems	D.M.Mithani & E.Gordon

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Lesson – 2

BANKING SYSTEMS IN INDIA

2.0 OBJECTIVES

After going through this lesson, student can understand -

→ The Banking Systems existed in the world.

→ Merits and demerits of Unit and Branch Banking Sytem.

→ Other Banking systems such as Group Banking, Correspondent Banking, Chain Banking, Deposit Banking, Investment Banking and Mixed Banking.

→ Recent Trends

Structure

2.1 Banking Systems
2.2 Branch Banking, Unit Banking
2.3 Advantages of Branch Banking
2.4 Disadvantages of Branch Banking
2.5 Advantages of Unit Banking
2.6 Disadvantages of Unit Banking
2.7 Banking System Suitable in India
2.8 Group Banking
2.9 Chain Banking
2.10 Correspondent Banking
2.11 Deposit Banking
2.12 Investment Banking
2.13 Mixed Banking
2.14 Recent Trends
2.15 Terminology
2.16 Self Assessment Questions
2.17 Reference Books

2.1 BANKING SYSTEMS

The banking systems in difernet countries vary substantially from one another. Banking system of a country depends on economic, political conditions of the country and also on traditions of the people. Various banking system existed are Branch Banking, Unit Banking, Group Banking, Correspondent Banking, Chain Banking, Deposit Banking, Investment Banking, Mixed Banking. However, of all the above Unit Banking and Branch Banking are the two important systems.

2.2 BRANCH BANKING – UNIT BANKING

Branch Banking : Under Branch Banking system, a big bank as a single institution and under single ownership operates through a network of branches spread all over the country. Initially, branch banking is developed in England. Later on, it became popular in other countries like Canada, Australia, India etc. In England most of the banking business is in the hands of five big banks i.e., the Midland, the Lloyds, the Barclays, the Westminister and the National Provincial. In terms of branches, the State Bank of India has emerged as one of the biggest banks.

Unit Banking System : Under unit banking system, an individual bank operates through a single office. The size and area of operations of a Unit Bank are much smaller as compared to those of a bank under branch banking system. According to Shapiro, Solomon and whit, "An independent unit bank is a corporation that operates one office and that is not related to each other banks through either ownership or control". Unit banking system originated and grew in the U.S.A.

The operations of banks in USA are not governed by one set of laws. Since states have also powers to enact banking laws, banks are governed by the legislative output of federal government and state governments. Some states do not allow opening of branches at all. Some states allow opening of branches within the state or a town. National Bank established under Federal laws can open branches any where.

Another characteristics features of American banking system is that the unit banks are linked together by the 'Correspondent System'. A bank in a small town has a correspondent bank in a neighbouring city, while the city bank inturn has its own correspondent bank in the financial centres – New York and Chicago. Thus practically all the unit banks are linked directly or indirectly to the big banks of New York. The main reason for the development of Unit banking system in America is the fear of emergence of monopoly in banking business. Another important feature of banking system of USA is the existence of 12 Central banks – The Federal Reserve Banks.

2.3 ADVANTAGES OF BRANCH BANKING

Rapid Growth and Wide popularity of branch banking system in 20th century are due to various advantages as discussed below :

(1) Economies of Large Scale Operations

Under the branch banking system the bank with a number of branches possesses huge financial resources and enjoys the benefits of the large-scale operations (1) Highly trained and experienced staff is appointed which increases the efficiency of management.(2) Division of labour is introduced in the banking operations which ensures greater economy in the working of the bank. Right persons are appointed at the right place and specialisation increases. (3) Funds are made available liberally and at cheaper rates (4) Foreign exchange is done economically, (5) Large financial resources and wider geographical coverage increases public confidence in the banking system.

(2) Spreading of Risk

Another advantage of branch banking system is the lesser risk and greater capacity to meet risk.

a. Since there is geographical spreading and diversification of risk, the possibility of the failure of the bank is remote.

b. The losses incurred by some branches may be offset by the profits earned by other branches.

c. Large resources of branch banks increase their ability to face any crisis.

(3) Economy in Cash Reserves

Under the branch banking system, a particular branch can operate without keeping large amounts of idle reserves. In time of the need, resources can be transferred from one branch to another.

(4) Diversification of Deposits and Assets

There is greater diversification of both deposits and assets under branch banking system because of wider geographical coverage.

(a) Deposits are received from the areas where savings are in plenty.

(b) Loans are extended in those areas where funds are scarce and interest rates are high. The choice of securities and investments is larger in this system which increases the safety and liquidity of funds.

(5) Cheap Remittance Facilities

Since bank branches are spread over the whole country, it is easier and cheaper to transfer funds from one place to another. Inter-branch indebtedness is more easily adjusted than inter-bank indebtedness.

(6) Uniform Interest Rates

Under branch banking system, mobility of capital increases and in turn brings about equality in interest rates. Funds are transferred from areas with deficit demand for money to areas with excessive demand for money. As a result, the uniform rate of interest prevails in the whole area.

(7) Proper Use of Capital

Under branch banking system, capital can be used properly. If a branch has excess reserves, but has no opportunity for investment, it can transfer the resources to other branches which can make most profitable use of these resources.

(8) Better Facilities to Customers

Under the branch banking system the customers are getting better and greater facilities. It is because of small number of customers per branch and increased efficiency achieved through large scale operations.

(9) Banking Facilities in Backward Areas

Under the branch banking system, the banking facilities are not restricted to big cities. They can be extended to small towns and rural as well as underdeveloped areas. Thus, this system helps in the development of backward regions of the country.

(10) Effective Control

Under the branch banking system, the Central Bank can have a more efficient control over the banks, because it has to deal only with few big banks and not with each individual branch. This ensures better implementation of monetary policy.

2.4 DISADVANTAGES OF BRANCH BANKING

Following are the main disadvantages and limitations of branch banking system.

(1) Problem of Management : Under the branch banking system a number of difficulties arise

with regard to management, supervision and control. They are (1) Management of banks are concentrated at the head office, the managers can afford to be lax and indulgent in their duties are often involved in serious irregularities while using the funds. (2) Branch Manager has to seek permission from the head office on each and every matter, this results in unnecessary delay and redtapism in the banking business.

(2) Lack of Initiative : Branch managers generally lack initiative in taking decisions on all important mattes. They can not take independent decisions and have to wait for the clearance signal from the head office.

(3) Monopolistic Tendencies : Branch Banking encourages monopolistic tendencies in banking system. A few big banks dominate and control the whole banking system of the Country through their branches. This can lead to the concentration of resources in a few hands.

(4) Regional Imbalances : Under branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the Country.

(5) Adverse Linkage Effect : Under branch banking system, the losses and weaknesses of some branches have their effect on the other branches of the bank.

(6) Inefficient Branches : In this system, the weak and unprofitable branches continue to operate under the protection cover of the large and more profitable branches.

(7) Other Defects : Other defects of branch banking are – (a) Preferential treatment is given to the branches near the head office. (b) Higher interest rates are charged in the developed area to compensate for the lower rates charged in the backward areas. (3) There is concentration and unhealthy competition among the branches of different banks in big cities. (4) Many difficulties are faced when a bank opens branches in foreign countries.

2.5 ADVANTAGES OF UNIT BANKING

Unit Banking has the following advantages.

1. Local Development

Unit banking is localised banking. The Unit bank has the specialised knowledge of the local problems and serves the requirements of the local people in a better manner than branch banking. The funds of the locality are utilised for the local development and are not transferred to other areas.

2. Promote Regional Balances

Under Unit banking system, resources of rural and backward areas are not transferred to the big industrial commercial centres. This tends to reduce regional imbalance.

3. Easy Management

The management and supervision of a unit bank is much easier and more effective. There are less chances of fraud and irregularities in the financial management of the Unit banks.

The manager of a local bank has greater chances of maintaining friendly and personal relationship with the customers in the locality. He can easily acquire the personal knowledge of his customers, which is essential for his success.

4. Initiative in Banking Business

Unit banks have full knowledge of and greater involvement in the local problems. They have initiative to tackle these problems through financial help.

5. No Inefficient Branches

Under unit banking system, weak and inefficient branches are automatically eliminated. No protection is provided to such banks.

6. No Monopolistic Tendencies

Unit banks are generally small in size. Hence, there is no scope for monopolistic tendencies under unit banking system.

7. No Diseconomies of Large Scale Operations

Unit banking is free from the diseconomies and problems of large scale operations which are generally by the branch banks.

2.6 DISADVANTAGES OF UNIT BANKING

The following are the disadvantages of unit banking system –

1. No Distribution of Risks

Under unit banking, the bank operations are highly localised. Therefore, there is little possibility of distribution and diversification of risks in various areas and industries.

2. Inability to Face Crisis

Limited resources of the unit banks also restrict their ability to face financial crisis. These banks are not in a position to stand a sudden rush of withdrawals.

3. No Banking Development in Backward Areas

Because of their limited resources, unit banks cannot afford to open uneconomic banking business in smaller towns and rural areas. Hence, these areas remain unbanked.

4. Lack of Specialisation

Because of their small size, unit banks are not able to introduce and get advantages of division of labour and specialisation. Such banks cannot afford to appoint highly trained and specialised staff.

5. Costly Remittance of Funds

A Unit bank has no branches at other places. As a result, it has to depend upon the correspondent banks for transfer of funds which is very expensive.

6. Disparity in Interest Rates

Since easy and cheap movement does not exist under the unit banking system, interest rates vary considerably at different places.

7. Local Pressures

Unit banks are highly localised in their business. Hence, the local pressures and interferences generally disrupt their normal functioning.

8. Undesirable Competition

Unit banks independently run by different managements. This resulting in an undesirable competition among the unit banks.

Although both branch banking system and unit banking system have their relative merits and demerits. But the merits of the former outweigh those of the later. There has grown a general tendency in favour of the branch banking system mainly because of large financial resources, economies of large operations and effective control by the central bank. Experience has shown that unit banking system is hampered by limited resources and does not work under economic depression. Now-a-day, the branch banking system is especially suitable for the underdeveloped countries. The entire banking system in India has developed on the lines of branch banking system.

2.7 BANKING SYSTEM SUITABLE IN INDIA

In India, about 70 percent of the population lives in rural areas. Unit banking system is not suitable to our country. India witnessed a number of bank failures when there are small banks. In 1956 there were 566 Commercial banks in the country. This number was declined to 73 by 1969. The reason may be the amalgamation of some banks and closure of some banks. The establishment of Regional Rural Banks increases the number of banks in the country. In March 2003, there were 289 scheduled commercial banks in the country.

The number of branches was only 8262 in 1969. With the nationalisation of banks and establishment of RRBs, he number of branches increased year after year. Branches were opened in unbanked centres and in rural and semi-urban areas. The number of branches by 2003 were 66,514. The percentage of rural branches which was 49 in 2002 declined to 48.7 by 2003.

Large volume of savings are dormant in rural areas. Branch network is necessary to mobilise these savings and make them for investment. Small banks are liable to fail. The failure of urban co-operative banks in recent years is a pointer in this direction. Moreover, the Reserve Bank of India finds it difficult to supervise and exercise control over a large number of unit banks.

In our money market, there is a vast unorganised sector. Unit banking system will complicate the system. Hence, branch banking is ideal and suitable system for India.

In June 1969, for population of 65,000, there was only one bank office. Now for every 15,000 population, there is one bank office. As a result, there has been a steady increase in per capita deposit and per capita credit. The per capita deposit in June 1969 is only Rs.68. In March 2000, it is Rs.8247. The percapita credit during the period increased from Rs.68 to 4750. Rural people are now provided loans by banks. Banks have been participating in Anti-poverty programmes. They are discharging their social responsibilities. This is possible because of branch banking system.

Based on the data of major Indian states, during 1961-2000, the following have been observed.

(a) Branch licensing policy succeeded in giving encouragement to commercial banks in opening branches in backward rural areas.

(b) Rural banks managed to reach the rural poor.

(c) Commercial banks encouraged households to save which accumulates capital that can be used for further investment in various productive activities.

2.8 GROUP BANKING

Group banking refers to the system of banking in which two or more banks are directly controlled by a corporation, an association or a business trust. The holding company may or may not be a banking company. Although each bank maintains its separate entity, but its business is managed by the holding company. This type of banking system was popular in U.S.A. between 1925-1929.

Group banking enjoys some advantages of branch as well as unit banking system. The main advantages are :

(1) Each member bank has its separate entity. It maintains its board of directors. At the same time, group banks enjoy the benefits of centralised administration. (2) There is greater liquidity and mobility of resources. In times of crisis, funds can be transferred from one bank to other. (3) There is economy of advertisement expenditure. There is also a common purchasing agency which leads to economy in purchases (4) Services of experts can be made available to the member banks to manage their business efficiently. (5) Common standardised accounting system improves the working of the member banks. (6) Large-scale banking operations allow superior credit facilities.

The main defects are :

(1) The control of member banks are under the group banking system is less direct and more flexible than that under branch banking. Thus, effective supervision is not possible. (2) Efficiency of the member banks is adversely affected by the management of the holding company which uses the banks as vehicles of manipulation and speculation. (3) The failure of one bank has its adverse effects on other member banks. (4) The common purchasing agencies often indulge in corrupt practises.

2.9 CHAIN BANKING

Chain banking is another form of group banking. It refers to the system in which two or more banks are brought under common control by a device other than the holding company. The common management may be by a single person or a group of persons through stock ownership or otherwise. This type of banking system was developed in U.S.A. towards the middle of 19th century and remained popular till the Great Dxpression of 1929. The advantages and disadvantages of chain banking system are more or less similar to those of group banking.

2.10 CORRESPONDENT BANKING

Correspondent banking has its origin in USA. Since it is the home of unit banking system. The unique featureof unit banking system is the existence of correspondent banking system. Thus, this system results in connecting all the unit banks throughout the country. Under unit banking system, all banks have established correspondent bank relations with each other all over the country and hence one bank is acting as an agent of another mainly for the purpose of clearing of cheques and movement of funds from one place to another. Under this system, the smaller banks are called respondent banks while the bigger banks are called Correspondent banks.

Functions

(1) Clearing outstation cheques.

(2) Transfer of funds from one place to another.

(3) Loan participation for their respondent banks.

(4) Strengthening the financial resources of respondent banks during tight money periods. The correspondent banks get benefit from the deposit funds of their respondent banks besides getting commission for the services rendered.

2.11 DEPOSIT BANKING

Deposit banking has its origin in England. Banks in England were confined only to accepting deposits and lending for short periods to industries and trade. The underlying principle of this system is that banks cannot lock up their deposits in long-term investments as the deposits are repayable on demand. In fact, banks were regarded as custodian as well as trustees to safeguard the deposits of the public. Hence, deposit banking system is free from supplying fixed capital requirements of industries in olden days.

2.12 INVESTMENT BANKING

Investment banking refers to a system where banks provide long-term finance to meet the fixed capital requirements of industries. Hence, it is also called Industrial Banking.

Industries need finance not only for short periods but also for long periods. Long term finances are required for acquiring fixed assets, modernisation, expansion of business and re-organisation of the industry. Prior to 1914, in Germany banks provide long term finance to industries. In addition to financing, banks in Germany, helped the industrialisation of the country by floating the new companies.

In our country UTI, LIC and GIC are considered as investment institutions. The UTI mobilises funds form the investing public by floating various schemes. In addition to UTI, there are mutual funds started by public sector banks and financial institutions, LIC and GIC. The money mobilised will be invested in shares and bonds of a variety of companies so as to minimise risk.

2.13 MIXED BANKING

The banking system which combines deposit banking with investment banking is known as Mixed Banking. Mixed banks receive deposits from public and provide short-term, medium-term and long term loans to industries.

Merits of Mixed Banking

1. The industrial units financed by the banks have the advantage of receiving their expert guidance on various financial issues.
2. Banks also benefited by acquiring a thorough knowledge of the working of the industrial system of the country.
3. The provision of long-term accommodation to industries enable the banks to invest their surplus resources for industrial development of the country.

Defects of Mixed Banking

1. This system constitutes a serious threat for the existence of the banks.
2. It is not a desirable practice to lock up the bank resources in long-term investments.

The German banks are mixed type. The banking system in India is of pure type right from the beginning. In recent years, particularly after nationalisation of major commercial banks, there has been a change in the investment pattern of the banks. They have started providing long-term industrial credit with a view to encourage industrialisation in the country.

2.14 RECENT TRENDS

Banks in India followed the British pattern of deposit banking. It was considered that the banks in India were not suited for mixed banking system. The importance of bank's role in industrial finance was reiterated by a number of committees. The central Banking Enquiry Committee in 1931 recommended a limited participation of Indian banks in Industrial finance. The Shroff Committee in 1954, recommended the participation in an indirect way, i.e., through purchase of shares and debentures in Industrial Finance Corporation and State Finance Corporations.

The latest developments are as follows :

1. The deposits in banks have increased manifold in the past years. The Reserve Bank has been taking various measures to strengthen the owned funds of the banks. Hence, the sound financial strength of banks enable the banks to take up this risk without any fear.
2. The Reserve Bank has established a number of specialised financial institutions like IFC, SFC, NIDC, and IDBI for providing medium term industrial finance.
3. The Commercial banks shedding away the traditional methods of lending and have started financing the expanding needs of the industry to a large extent. They underwrite the shares and debentures of the specialised institutions and grant term loans to industries.
4. The Reserve Bank provided refinance facilities for those banks entering into industrial finance.
5. Most of the banks have a separate division, i.e., Merchant banking division to deal with the promotion of industries.
6. Commercial banks have been permitted to form subsidiary companies for launching mutual funds and thereby raising a large corpus from small investors. This can be invested on shares and debentures of industries besides government securities. Thus, the banks promote industrial development in an indirect way also,
7. Banks have set up venture capital funds to finance high technology projects.

In the light of these developments, mixed banking is gaining momentum in India.

2.15 TERMINOLOGY

1. Branch Banking

If a big banking institution under single ownership operates through a network of branches spread all over the country, the system is known as Branch Banking System.

2. Unit Banking

If an individual bank operates through a single office, the system is unit banking system.

3. Mixed Banking

The system under which the Commercial banks meet both short term as well as long term loans to industries is mixed banking system.

4. Investment Banking

The system under which the banks provide capital requirements of industries in Investment Banking System.

5. Deposit Banking

The system under which receiving deposits and lending for short periods to industries and trade is Deposit Banking System.

6. Chain Banking

The system, where two or more banking companies are controlled by one or few individuals is chain banking system.

2.16 Self Assessment Questions

5 Marks Questions

1. Chain Banking

2. Deposit Banking

3. Investment Banking

4. Mixed Banking

5. Group Banking

6. Correspondent Banking

10 marks Questions

1. Explain the advantages of Branch Banking.

2. Explain the advantages of Unit Banking.

3. Which is the suitable banking system for India in your opinion ?

20 Marks Questions

1. Explain the advantages and disadvantages of Branch Banking.

2. Explain the advantages and disadvantages of Unit Banking.

2.17 REFERENCE BOOKS

Banking and Financial Systems	A.V.Ranganadhachary & R.R.Paul
Banking and Financial Services	S.N.Maheswari & R.R.Paul
Banking and Financial Systems	D.M.Mithani & E.Gordon

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Lesson - 3

COMMERCIAL BANKING IN INDIA

3.0 Objectives : After going through this lesson student can understand.

→ History and present position of Commercial Banks.

→ Factors favourable for nationalisation.

→ Factors opposing nationalisation.

→ Achievements of bank after nationalisation.

Structure

3.1 Introduction - Money Market
3.2 History of Commercial Banks
3.3 Nationalisation of Banks
3.3.1 Arguments for Nationalisation
3.3.2 Arguments against Nationalisation
3.3.3 Objectives of Nationalisation
3.3.4 Achievements of Nationalisation
3.4 Terminology
3.5 Self Assessment Questions
3.6 Reference Books

3.1 Introduction - Money Market

Economic development of any country depends on the development agricultural, industrial and service sectors . The development of these sectors is possible only when there is huge investment policy. Hence, Every country should have a strong financial system. Money market is the basis for an effective monetary policy. Money market mobilises savings from different sources and make them available for investment. It is sthe mechanism through which funds flow from surplus units to deficit units in the economy.

Financial markets are functionally classified into (1) money market and (2) capital market. Money market refers to the institutional arrangements which deal with short-term funds where as the capital markets deals with long-term funds. Money market is a short-term credit market which deals with relatively liquid and quickly marketable assets such as short-term government securities, treasury bills, bills of exchange etc. According to Crowther “The money maket is a collective name given to the various firms and institutions that deal with various grades of near-money”. 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”.

Constituents of Indian Money Market

The money market in India comprises two sectors.

(1) Organised Sector : (a) The organised sector comprises of the Reserve Bank of India (b) State Bank of India with its seven associates. (c) The Indian Joint Sock Commercial banks (scheduled

and non-scheduled) of which 27 scheduled banks have been nationalised (d) exchange banks which Finance Indian Foreign Trade. (e) Co-operative Banks (f) Other special institutions such as Industrial Development Bank of India, State Finance Corporation, National bank for Agriculture and Rural Development, export and Import Bank, (g) Quasi- government bodies and large companies also make their funds available to the money market through banks.

Unorganised sector : The unorganised sector comprise numerous indigenous bankers, village money-lenders and non-banking insitutions. It is unorganised becuase its activities are not controlled and co-ordinated by the Reserve Bank of India.

3.2 History of Commercial Banks

Commercial banking in India began in 1770 with the establishment of first Joint Stock Bank, named the bank of Hindustan in Calcutta. But it was failed in 1832. The real beginning of the modern commercial banking in the country was made with the establishment of Bank of Bengal in 1806. Later, Bank of Bombay and Bank of Madras were also set up in 1840 and 1843 respectively. These banks were called the presidency banks, they were partly financed by East India Company and they were given the right of note issue in their own regions.

In 1881, the first indegenous bank, oudh Commercial Bank was started. It was followed by setting up of Punjab National Bank in 1894 and People’s Bank in 1901. The Swadeshi movement of 1905 encouraged the growth of commercial banks in India. Then came the period of banking crisis. During 1913-48, 1100 banks were failed. The Reserve Bank of India, the Central Bank of our Country, came into existence in 1935. But the pitable state continued. The birth and death rates of banks are high, until Banking Regulation Act, 1949 was passed. It weeded out a large number of unviable banking companies. The RBI acquired a supervisory and development role.

Another major development in the history of Indian banking was the establishment of State Bank of India in July, 1955, by nationalising the Imperial Bank of India. The period of multi-dimensional expansion of the banking sector begins with the nationalisation of the major banks in 1969.

The financial sectors reforms in 1990s opened up the banking sector to private banks in 1993. Nine new sector banks were started. But with the merger, their number came down to eight. Some of the term lending institutions (ICICI and IDBI) which have sponsored the bank are trying to become universal banks.

With a view to provide credit in rural and semi-urban areas, Local area banks were permitted to be established. The related guidelines were announced by the RBI in 1997. Licences were issued to LABs.

Scheduled and Non-scheduled Banks

Modern banks in India are Joint Stock Banks. They are registered under the Indian Companies Act. They are classified by the Reserve Bank of India into two categories 1) Scheduled Banks 2) Non-Scheduled Banks.

Scheduled Banks : See 42(b)(a) of the Reserve Bank of India Act, 1934 lays conditions for a bank to become eligible to be a scheduled Bank. They are 1) The bank must have a paid up capital and reserve of not less than Rs.5 Lakhs. 2) It must satisfy the RBI that its affairs are not being conducted in a manner detrimental to the interest of depositors. 3) It must be a company as defined by the Companies Act, 1956 or Corporation established by an Act of Parliament. These conditions are fulfilled, it may direct the bank for inclusion in the second schedule of the RBI Act.

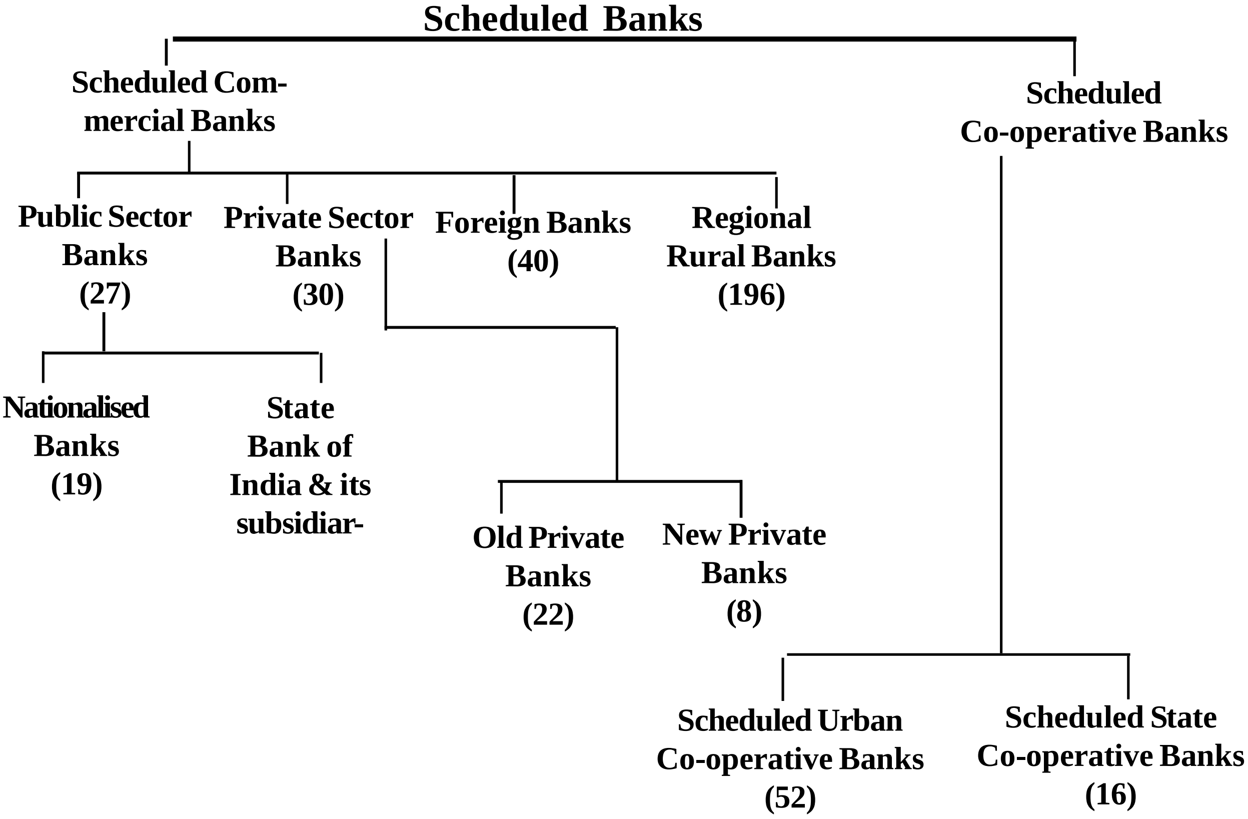
A foreign bank incorporated under any law in force in any place outside India can also become, scheduled bank with effect from 1966, State Co-operative banks have also become eligible to become scheduled banks. Later urban cooperative bank are also made eligible to become scheduled banks.

Non-scheduled Banks : Banks which is not included in the second schedule of RBI Act are non-scheduled banks. Presently there is no non-scheduled commercial bank in India.

Present Position

At present(March 31, 2001) there are 296 scheduled Commercial Banks in India. Of these 27 are public sector banks, 196 are Regional Rural banks, 42 Foreign banks and 31 are in Private sector. The structure of Commercial banking in India is as follows :

Structure of Commercial Banking in India(March 31, 2001)


Scheduled Banks
Scheduled Commercial Banks
Scheduled Co-operative Banks
Public Sector Banks (27)
Private Sector Banks (30)
Foreign Banks (40)
Regional Rural Banks (196)
Nationalised Banks (19)
State Bank of India & its subsidiar-
Old Private Banks (22)
New Private Banks (8)
Scheduled Urban Co-operative Banks (52)
Scheduled State Co-operative Banks (16)

3.3 Nationalisation of Banks

In 1960s the commercial banks in India provides financial facilities to few big industrial houses only little efforts were made by the banks to meet the credit requirements of agriculture, small-scale industry which are backbone of Indian economy. But banks in the planned economy should scater their credit facilities to all the productive sectors. To promote social and economic position of the country, in 1968, the central government imposed Social Control on banks. Due to its failure, government recognised the need of nationalisation of Banks. Without nationalisation of banks it is not possible to achieve social control in the country. As a result, on July 19, 1969 the Government of India through an Ordinance, nationalised 14 major commercial banks in the country. Again on April 15, 1980 six more commercial banks were nationalised.

3.3.1 Arguments for Nationalisation

The bank nationalisation in India is mainly based on the defective ownership, biased credit policy and unhealthy practices of the banks in the pre-nationalised period. The main arguments in favour of bank nationalisation in the country are as follows :

1 Ownership and Control : Indian banks were owned and controlled by a few big shareholders. They influence the pattern of allocation of bank credit is accordance with their own interests. The nationalisation of banks would bring banks under the control of government for meeting the general interest of the public.

2. Concentration of Wealth and Power : Banks in India were controlled by a few industrial houses which used the public funds of the banks to build up huge industrial estates. Banks provide credit facilities to those few. This led to the growth of wealth and power in a few hands.

3. Credit to Directors : The resources of the banks were made available to the directors of these banks at concessional rates. These directors also have connections with other business concerns. The funds of the banks were utilised for the promotion of the interests of the directors. Bank nationalisation would check favourable attitude of the banks towards directors.

4. Speculative Activities : Previously, funds of the banks were mostly used for hoarding and speculative purposes. All social elements were able to receive the bank loans to make large profits by creating artificial shortage of essential goods. Such misuse of bank resources would be controlled by the nationlisation of banks.

5. Discrimination against small business : Indian banks had adopted a general policy of providing finance to large industries. Small businesses were not able to approach these banks for meeting their credit needs and were usually discriminated against. Nationalisation was favoured in order to extend financial help to the small business units.

6. Indifference to Agricultural Sector : The agricultural sector was almost ignored by the Commercial banks. Most of the banks and their branches existed in the urban areas and were catering the needs of the industry and trade. Little efforts were made by the banks to meet the credit requirements of agriculture which is the backbone of the Indian economy. Nationalisation of banks was hoped to contribute to the development of agriculture.

7. Financing Economic Plans : It was argued that the nationalised banks would make their resources available to the government for financing economic plans of the country.

8. Safety of Depositors : Nationalisation will provide 100 percent safety to the deposits of the people. This will acquire the public confidence and thus increases the bank deposits.

9. Economic Planning : Economic planning needs nationalisation of banks. Private banks may not give the necessary cooperation to RBI in controlling inflation and deflation. Banks may voilate the directives and guidelines of RBI. The nationalisation of banks will encourage new class of enterpreneurs, which leads to economic growth.

10. Creation of Socialist pattern of Society : Nationalisation is necessary for achieving socialism.

11. Other Arguments : (1) Nationalisation eliminates wasteful competition and raises the efficiency of the working of the banks. (2) Integrated monetary policy and its effective implementation requires unified control of both the central and the commercial banks.

3.3.2 Argument Against Nationalisation

Those who oppose nationalisation of banks gave the following arguments:

1. Reduction in Efficiency : The experience of other nationalised institutions indicates that the nationalisation of the commercial banks will reduce the efficiency of these banks. Moreover, political interference will also impair the smooth working of these institutions.

2. No Control on Monopolies : The root cause of the growth of monopolies and the concentration of wealth and power lies in existing economic system. Therefore, the remedy requires the changing and reforming of the economic system and not the nationalisation of banks.

3. Other ways to remove Malpractices : Malpractice of privately owned banks can be checked by adopting appropriate monetary and fiscal policies and through efficient supervision by the Reserve Bank of India. There is no need to take such a drastic step of bank nationalisation.

4. Risky lending to Agriculturists : Extending loans to agriculture and small scale industries is risky and less remunerative. Such loans are against the sound banking rules and may weaken the economic viability of these institutions.

5. No need of security to deposits : It is pointed out that there is no need to provide 100 percent security to the depositors in India through nationalisation of Banks. Institutions like Indian Deposit Insurance and Credit Guarantee Corporation are functioning quite efficiently and providing enought relief to the depositors.

6. No Socialism : It is argued that nationalisation may not lead to socialism. State Capitalism is not socialism. Moreover, there is a general tendency treat public property not as sacred national property, but as no one's property. As such, it is misused and destroyed like anything.

7. Burden of Compensation : Nationalisation involves huge amounts of money to be paid as compensation to the shareholders. This puts additional financial burden on the government. Moreover, it is also argued that nationalisation will not bring much revenue to the state.

3.3.3 Objectives of Bank Nationalisation in India

The Government of India nationalised 14 major banks with deposits of more than Rs.50 crores with effect from July 19, 1969 by passing the Banking Companies Act, 1969. The aim of nationalisation of banks is "to control the heights of the economy and to meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives". More specifically, the important objectives of bank nationalisation outlined are

1. to mobilise savings of people to the largest possible extent and to utilise them for productive purposes.

2. to ensure the legitimate credit needs of private sector, industry and trade, big or small are met.

3. to ensure that the operations of the banking system are guided by a large social purpose and are subject to close public regulation.

4. to ensure that the needs of the productive sectors of the economy and in particular those of famers, small scale industrialists and self-employed professional groups are met.

5. to actively foster the growth of the new and progressive enterpreneurs and creates fresh opportunities for hitherto neglected and backward areas in different parts of the country, and

6. to curb the use of bank credit for speculative and other unproductive purposes.

The banks that were nationalised on July 19, 1969 are

1. Central Bank of India
2. Punjab National Bank
3. United Commercial Bank
4. United Bank
5. Union Bank
6. Syndicate Bank
7. Indian Bank
8. Bank of India
9. Bank of Baroda
10. Canara Bank
11. Dena Bank
12. Allahabad Bank
13. Indian Overseas bank
14. Bank of Maharashtra.

In April 1980, six more banks wee nationalised. They are (1) Andhra Bank, (2) Corporation Bank, (3) Vijaya Bank, (4) Punjab and Sind Bank, (5) Oriental Bank of Commerce, (6) New Bank of India (merged with Punjab National Bank in 1993).

3.3.4 Achievements of Nationalisation

For various reason, commercial banks in India used to cater mainly to the needs of big industries and wholesale trade. They have ignored all these years many sectors ranking high in social priorities such as agriculture, small scale industry, professional people. etc. Only people with urban out look and background had the benefit of banking facilities. Borrowers and small means engaged in productive effort had little acess to banks. Besides, over these years there had been wide disparities in the distribution of office and credit between regions and between urban and rural areas. To correct such imbalances, 14 major Indian banks were nationalised in July, 969 and 6 more in 1980.

The major task of nationalisation is to meet the credit gaps in the economy. For this purpose mobilisation of deposits on massive scale has become necessary. This has necessitated changes in the policies and practices of banks. After Nationalisation, many banks came out with schemes for extending more credit in a liberal manner to people with small means. There were significant changes in the lending policies of banks in respect of small farmers, businessmen, retail traders and self-employed professionals. Banks have been competing with each other to take banking facilities to the doorsteps of people. People of all corners of the society are the new clients of the bank credit. Banking for the elite has become banking for masses. The era of social banking started. After nationalisation, achievements of the banks are:

Branch Expansion of Commercial Banks 10969 - 2002			
	1969	*1991*	*2002*
Rural	1832	35212	20413
	22.4%	58.4%	39.6%
Semi-Urban	3322	11281	12664
	40.1%	18.7%	24.5%
Urban	1447	7630	10059
	17.5%	12.7%	19.5%
Cities	1661	6128	8358
	20%	10.2%	16.4%
Total	8262	60251	51494
	100%	100%	100%

A. DEVELOPMENT OF BANKING INDUSTRY

1. Branch Expansion :Rapid economic development pre-supposes rapid expansion of commercial banks. There has been a spectacular expansion of bank branches after nationalisation of banks. The Lead Bank scheme has played an important role in the bank expansion programme. The number of branches of all scheduled commercial banks increased from 4151 to 8262 (during 1951-1969) during 18 years of pre-nationalisation period and gone up from 8262 to 66,640 during (1969-2003).

M.Gopala Krishnan, a pofessional banker states that “The single striking feature of the post-nationalisation banking scene is the rapidity with which the branch net work has multipled itself. The rate of branch expansion has been unparalleled anywhere else in the world”. With this progress, the average population per bank office has declined from 64,000 to 15,000.

Progress of Commercial Banks 1969-2002

	1969	1990	2002	
1. No. of Scheduled Banks	73	270	299	
2. Regional Rural Banks			196	
3. Bank Offices		8,262	59,752	66,640
4. Population per bank office	64,000	14,000	15,000	

The above table showed the branch expansion of commercial banks in rural and urban areas. In June 1969 in rural areas there were 1832 branches and were increased to 35,212 in 1991. But later it was declined to 20413 by 2002. In 1969 there were 3322 branches in small towns and it increased to 11281 in 1991 and 12664 in 2002. It is clearly understood that the branch expansion was increased in 1991 but later declined by 2002. Hence, most of the branches in rural areas were closed. But the expansion was better in towns and cities. Some banks have started mobile offices and satellite offices. Rapid expansion of branches of Commercial banks with the help of lead bank scheme has led to integration of rural and urban and as well as integration of organised and unorganised money maket in India.

2. Mobilisation of Deposits : Since nationlisation of banks, there has been a significant increase in the deposits of Commercial banks. Planned economic development, deicit financing and increase in currency issue have led to increase in bank deposits.

Deposits of Commercial Banks

Year	Deposits (Rs. Crores)
1951	908
1969	4,646
1991	1,92,540
2003	15,01,930

In general, there has been regular and continuous rise in bank deposits indicating clearly that banking habit is growing in India. During pre-nationalisation period of 18 years, deposits of banks increased from Rs.908 crores in 1951 to Rs.4646 crores in 1969 (about 5 times increase). During 18 years of post nationalisation period, the deposits increased from Rs.4646 crores to Rs.1,07,345 crores in 1987 (about 26 times increase)

There are various reasons for the increase of bank deposits in India especially after bank nationalisation. They are

1. Rapid branch expansion.
2. Increase in the amount of cash with the banking system.
3. The smaller ratio of cash reserves.
4. Favourable business conditions in the country.
5. High rate of interest on bank deposits.

3. Bank Credit : After nationalisation of banks there has been continuous expansion of bank credit in the country, which reflects the rapid expansion of industrial and agricultural output. The banks are also meeting the credit requirements of industry, trade and agriculture on a much larger scale than before.

Year	Bank Credit (Rs. Crores)
1951	580
1969	3,599
1991	1,16,300
2003	8,35,380

Just as bank deposits have expanded, bank credit too has expanded tremendously year after year. In recent years, bank credit has picked up by around 20 to 21 percent per year. Following are the factors responsible for the growth of bank credit.

1. Large reduction is reserve requirements of banks i.e., CRR and SLR

2. Fall in rates of interest charged due to RBI's cheap money policy

3. Increased demand for credit from public sector undertaking and large increase in export credit.

4. Release of impounded cash balances under Incremental Cash Reserve Ratio (ICRR).

4. Coverage of Rural Areas : Rural areas were starved of banking facilities. The main idea of nationlisation is increasing the banking facilities in the rural areas. There had been a significant increase in rural branches since 1969. The percentage of bank branches in rural areas to total branches has risen from 22.4% (1832 branches) in 1969 to 58.4% (35212 branches) in 1991.

5. Reduction of Regional Imbalances : Commercial banks undertook a programme of massive expansion of bank branches in the rural, under-banked and unbanked areas, which aimed at ensuring balanced regional development of banking sector in the country. The licensing policy adopted by the commercial banks aim at achieving a coverage of 15,000 population per bank in rural and semi-urban areas of each development block. The policy also aims at providing a bank office within 10 kms each village.

6. Change in Composition of Deposits : The proportion of demand and time deposits have also changed significantly after the nationalisation of banks. The proportion of time deposits has increased continuously from 50% in 1951 to 75% in 1969 and further nearly 85% in 2002. This shows the favourable shift of fixed deposits of the commercial banks.

7. Investment in Government Securities : There has been a remarkable increase in the investment of banks in Government and other approved securities for providing finance for economic plans of the country..

B. FINANCING OF PRIORITY SECTORS

Before 1969, commercial banks has largely neglected agriculture because that the rural credit was met by co-operative societies and banks. Hence, banks neglected the credit needs of the farmers for agricultural operations and for land improvements. This was the basic reason for the failure of planning in agricultural sector, which leads to failure of general planning. At the same time, before nationalisation banks were controlled and managed by big industrialists. As a result, small industries and business units were ignored by banks.

Soon after nationalisation, commercial banks were asked to concentrate on financial requirements of priority sectors of agriculture, small industry, business units, and other priority sectors such as retail trade, self-employed persons, housing loans, education loans etc.

In 1980, RBI issued certain directives to the banks regarding priority sector leading:

1. Piority sector advances should constitute 40 percent of aggregate bank creidt.

2. Out of priority sector advances, at least 40 percent should be provided to agriculture.

3. Direct advances to the weaker sections in agriculture and allied activities in rural areas should form at least 50 percent of the total direct lending to agriculture.

4. Bank Credit to rural artisans, village craftsmen and cottage industries should be atleast 12.5 percent of the total advances to small scale industries and

5. About 12 percent of bank credit should go to exporters.

The commerical banking system, particularly public sector banks undertook to priority lending enthusiastically. Following table shows the advances to priority sectors by public sector.

Advances to Priority Sectors (Rs. crores)

Priority Sector	*1969*	*1971*	*2003*
1. Agriculture	160	340	71,609
2. Small Scale Industries	260	440	60,486
3. Other priority sector	20	130	71,704
Total	440	910	2,03,880
4. Total Bank Credit	3020	4080	6,16,085
5. Percentage of priority sector advances to total bank credit	12	25	34

The total credited extended by public sector banks to all the priority sectors went up from Rs.440 crores in 1969 to Rs.910 crores in 1971 and further to Rs.2,63,830 crores. Similarly bank provide credit to small scale industries and other priority sectors significantly.

The Narasimham Committee (1991) was against the continuance of priority sector lending becuase of the low success of recovery of debts in agriculture and small scale sectors.

1. Agricultural Finance : After nationalisation, the commercial banks have been giving special attention to the financial needs of agriculturists and of rural areas. The creidt extended to agriculturists was increased in size and in proportion also. In 1969 agriculture credit was 5.4% but increased to 15.8% in 2000. Following are the steps taken by banks in providing credit to agriculturists.

a. Agricultural Development branches opened by many banks.

b. Introducing village adoption schemes.

c. Setting up of Gram Vikas Kendras.

d. Project lending with refinance facility from NABARD.

e. Setting up of Regional Rural Banks.

f. Farmer’s Service Societies in Small Farmers Development Agency areas.

g. Introducing Kisan Credit Card Scheme

h. Selecting groups of villages in different areas and meeting total credit needs of farmers in those villages.

2. Lesser importance to Big Industries : After nationalisation, the sectorial development of creidt has tremendously changed. In the pre-nationalisation, large and medium industries and whole sale trade account for about 78% of total bank credit and agriculture accounted only for 2.2% of total credit. The share of large and medium industries and whole sale trade in total bank credit has declined to 33% in 2000. Correspondingly, the share of agriculture, small industries and other priority sectors has increased.

3. Bank Credit to Small Scale Industries : Government recognised the small scale industries as an important. Productive sector of the economy, which needs financial assistance from commercial banks. After nationalisation, through banks government provided vairous facilities and conces-

sions to this sector. In 1969 Rs.260 crores of credit was extended to small industries and it increased to Rs.56,002 crores in 2002.

Special cells have been set up in the banks to provide guidance to the borrowers from small scale sector. Industrial estates and Deposit Insurance and Credit Guarantee Corporation provides financial assitance to small industries. IDBI and SIDBI are refinancing loans and advances extended by the commerical banks to small scale industrial units.

4. Export Promotion : In a developing economy like India, it is necessary to promote export in order to earn sufficient foreign exchange to meet the country's large and growing foreign exchange obligations. Keeping this in mind, government has taken necessary steps to enable the commercial banks to provide sufficient and easy finance to exporters. The financing is done at concessional rates of interest.

5. Housing Finance : Housing finance is another priority sector and public sector banks play a crucial role in this area. To meet the demand for housing finance following measures have been taken.

a. National Housing Bank at national level was set up in 1980.

b. Housing and Urban Development Corporation of India Ltd. (HUDCO)

c. Housing Development Finance Corporation Ltd. (HDFC).

The outstanding amount of housing loans by public sector banks has increased from Rs.323 crores in 1992 to Rs.5366 crore in 1999.

C. SOCIAL BANKING

1. Credit to Weaker Sections : The weaker sections include small and marginal farmers, landless labourers, tenant farmers, share croppers, artisans, village and cottage industries, beneficiaries of IRDP, scheduled castes and tribes, and beneficiaries of diferential rate of interest scheme. These weaker sections have been provided the bank credit of Rs.19608 crores in 1999 which is 7.8 pecent of the total credit of public sector banks.

2. Diferential Rate of Interest Scheme : With a view to povide bank credit to the weaker sections of the society at a concessional rate, the goverment introduced the differential rate of interest scheme from April, 1972. under this scheme, the public sector banks have been providing loans at 4% rate of interest to the weaker sections of the society who do not have any tangible security to offer, but who can improve their economic condition with the financial support from the banks. The scheme has shown notable progress. In March 1999, the outstanding differential rate of interest credit was of Rs.508 crore.

3. Bank Credit for IRDP : Integrated Rural Development Programme (IRDP) is a pioneering programme for removing imbalances in the rural economy and for all-round progress of the rural areas. This prgoramme envisages capital subsidy and credit assistance to identifies poor families for acquiring income generating assets to improve their standard of living. During the Seventh Plan (1985-1990) banks had assisted over 18.2 million persons, of which 8.2 million persons belonged to SCs/STs and 3.4 million were women. Total advances disbursed during 1995-96 by the banks amounted to Rs.1250 crore as agaisnt Rs.1425 crore in 1994-95. The total number of beneficiaries assisted during 1995-96 was 28.59 lakh as against 21.82 lakh in 1994-95.

4. Advances to SC/ST Borrowers: People belonging to the scheduled castes and scheduled tribes have been recognised as the most vulenerable sections. Banks have been asked to make special efforts to assist them adequate credit to enable them to undertake self-employment ventures and acquire income-generating capital assets. At the end of March 1999, the total outstanding amout of loan extended to SCs/STs by public sector banks was Rs.7410 crore in 87.58 lakh borrowal accounts as against Rs.4728 crore 98.14 lakh borrowal accounts in June 1994.

5. Kisan Credit Card Scheme : Kisan Credit Card Scheme was introduced in 1998-99 to provide better access to short-term institution credit (i.e. from commercial banks and Regional Rural Banks) to farmers. the sailent features of the scheme are given below:

i Farmers eligibel for production credit of Rs.5000 or more eligible for issue of Kisan Credit Card.

ii Eligible farmers are to be provided with a Kisan Card and passbook or Card-cum-passbook.

iii There is a provision of revolving cash credit facility involving number of drawals and repayments within the limit.

iv Entire production credit needs for full year plus ancil activities related to crop production are to be considered fixing limit.

v Limit will be fixed on the basis of operational land holding, pattern and scale of finance.

vi Sub-limits may be fixed at the discretion of banks.

vii Card will be valid for 3 years subject to annual review.

viii Each drawal has to be repaid within 12 months.

ix Conversion/reschedulement of loans are also permissible in case damage to crops due to natural calamities.

x As incentive for good performance, credit limit can be increased.

xi. Security, margin, rate of interest will be as per RBI norms.

xii.Operations may be through issuing branch or at the discretion bank, through other designated branches.

xiii.Withdrawals will be through slips/cheques accompanied by and passbook.

The scheme has gained popularity and its implementation has taken up by 27 commercial banks, 334 Central Cooperative Banks, and Regional Rural Banks upto December, 2000.

D. INNOVATIVE BANKING

The whole history of the development of banking system in Indian independence, particularly after the bank nationalisation in 1969, is a still enmerous diversifications and innovations introduced in the functioning of banks with a veiw to expand and improve their performance in accordance with the changing needs of the economy. Important innovations in banking which have been introduced recently are discussed below :

1. Social Banking : After nationalisation, the commercial banks in India have adopted a new policy orientation to meet the socio-economic obligations of the country. The important aspects of this social orientation are given below :

i Alignment of credit policy with the overall objectives of the government.

ii Allocation of credit in accordance with the requirements of the planned economic development of the country.

iii Reduction of regional disparities in the spread of banking to acheive the balanced development of the country.

iv A lead role in the development of credit at the district level.

v Greater financial assistance to the priority sectors of the economy and weaker sections of the society on easy and convenient terms.

2. Consortium Approach : Consortium approach to lending was introduced by the RBI in 1974. According to this approach, more than a bank would finance a single borrower requiring larger credit limits. This approach -

(a) enables banks to spread risk of lending;

(b) breaks the monopoly of big banks to have larger spread risk acocunts;

(c) enables banks to share experience and expertise;

(d) introduces uniformity in approaches to lending;

(e) evolves banks to pool their resources; and

(f) checks multiple financing of the same account.

3. Credit Card Facility : Commercial banks introduced credit card facility in the early 1980's. Since then, this facility has become increasingly popular among the banks as well as the public. Important features of credit card facility are given below :

i) The credit card is a document of cardholder's creditworthiness on the one hand and minimises the use of hard cash in the day-to-day transactions.

ii) It is a convenient medium of exchange which enables its holde to buy goods and services without using money.

iii) No matter where the cardholder is, he does not have to worry about to carry enough money for his purchases.

iv) Credit card helps its holder to buy when he wants and to pay when he can.

v) Credit cards are issued to people having a certain minimum income.

vi) The card holder is required to pay neither an interest nor a higher price for the goods purchased.

vii) The banks meets the cost of this facility from increased sales which results from the use of credit cards.

viii) The card-issuing banks pays to the seller as soon as the goods are sold, but charges the price from the buyer after 30 to 45 days.

ix)The bank also bears the risk of default on the part of cardholder.

x) For all this, the bank gets commission from the seller which is about 2.5 to 5% of the value of goods sold.

xi) The net gain of the bank is the amoun of commission from the seller minus interest factors, and administrative and advertisement costs.

xii) In addition, the bank also earns by way of initial, annual, add-on, and re-issue fees from the prospective cardholders.

xiii) Credit cards are mostly used by elite corporate executives, businessmen, middle income groups, etc.

xiv) Credit cards are normally use to purchase consumer durables, and certain services from the establishments, such as shops, departmetnal stores, hospitals, railways, hotels, etc.

xv) By the end of 1997, more than 11 banks were providing the credit card facility.

xvi) The latest generation cards now available in India include ATM Cards, Change Cards, Phone Cards, Pre-paid Mobile SIM Cards, Smart Cards. Electronic 'Smart Point' is likely to be the next development in this field.

4. New Technology : The commercial banks now are fast introducing mechnaisation, computerisation and many new techniques in their operations with the objective of improving the customer service productivity and Operational efficiency.

5. Consolidation Phase : Since mid-1980, banks have also entered the phase of consolidation, increased sophistication and greater productivity. The principles of viability, efficiency, prudence and pofitability are now receiving as much attention as social banking. Consolidation with moderate and selective expansion are the key words in banking operations. Apart from social functions the banks would now pay greater attention to -

(a) improvement in financial viability,

(b) selective modernisation and computerisation,

(c) better consumer service,

(d) better managerial culture,

(e) adequate profitability,

(f) strong and healthy organisational structure, and

(g) effective system of internal supervision, control, house-keeping and training.

6. Merchant Banking : Commercial banks have entered into merchant banking business. They have set up merchant banking divisions and underwriting issues. Some of the banks have set up separate subsidiaries and offer wide range of merchant banking services. At the end of 1991, comerical banks have started their equipment leasing and merchant bank subsidiaries.

7. Mutual Funds: Mutual funds (or unit trusts) are either open-ended or close-ended financial intermediaries which obtain their resources by selling units or shares. They enable small investors to obtain high return-low risk combination from their indirect holding of equities and other assets. They are either income-oriented or growth oriented or income and growth-oriented funds and offer many other financial services such as insurance, stock exchange, housing and bank loans, etc., their investors. On the invesment side, mutual funds may specialise in using their funds in different areas. Depending upon this, they may be called Common-Stock Funds, Bonds Funds, Balanced (Mixed) Funds, Municipal Bond Funds, Money Market Funds, Real Estate Investment Funds, etc.

Till 1986, UTI had a monopoly of mutual fund business in India. Now many other mutual funds have also come up in the market. In the banking sector, mutual funds have been set up mainly by the merchant banking subsidiaries of some public sector banks, such as , the State Bank of India, Canara Bank, Punjab National Bank, Bank of India, Indian Bank, Andhra Bank, LIC and GIC also have set up mutual funds. Besides, private sector mutual funds are also coming up. Most of the schemes of mutual funds in India are closed-end schemes.

8. Retail Banking : Commercial banking in India ae increasingly taking up retail banking as an attractive maket segment with opportunities for growth and for profit. Retail banking refers to housing loans, consumption loans for purchase of durables like refrigerators, TVs, air conditioners, auto loans, credit cards, educational loans. The loan value can average between Rs.20,000 to Rs.1 crore. The loans are generally for a duration of 5 to 7 years, with housing loans granted even upto a period of 15 years. Retial banking has been facilitated by growth in banking technology and automation of banking processes.

9. ATMs: ATMs (Automated Telle Machines, or “anytime money” as one bank has been wittily advertising) have emerged as an alternative banking channel which facilitate low cost banking transaction. Bank customers need not go to the bank branches but can withdrawn money and deposit cheques in ATMs.... These are the normal purposes for which persons go to a bank. This is now avoided by the neighbourhood ATM. The use of ATMs by foreign banks and pivate sector banks has helped these banks to expand their reach and compete effectively with public sector banks (PSBs). PSBs, in their turn, are also rapidly introducing ATMs.

10. Anywhere Banking: Anywhere Bankingis the new system of banking adopted and made popular by a few foreign banks and is now being increasingly adopted by PSBs. This faciliy is a technology based customers. under this system, a customer having an account with any select branch can operate it from other designated branches of the bank throughout the country. The facility includes cash withdrawal, cash deposit, transfer of funds, collection of local cheques, intra-city and intercity transactions, etc. Now distance is no hindrance and banking is made more convenient, wherever the consumer may reside.

11. Internet Banking In India : Growth of the Internet and wireless communication technologies, advances in telecommunications, etc. have dramatically changed the structure and nature of banking and financial services. However, internet banking is only in a rudimentary stage in India. Even then with the purpose of promoting safety and soundness of e-banking activities and as a precautionary measure, RBI has issued guidelines to the banks on internet banking covering:

(a) the risks associated with internet banking.

(b) the technology and security standards for internet banking;

(c) legal issues relating to this new type of activity, and

(d) the regulatory and supervisory concerns of RBI.

12. Venture Capital Funds.: One public sector bank subsidiary and one foreign bank have launched venture capital funds (VCF). the purpose of VCF is to provide equity cpaital for pilot plants attempting commercial application of indigenous technology and adaptation of previously imported technology to domestic conditions. The Government of India has issued detailed guidelines and procedures for establishment of VCF, management structure, size and investment of the funds, etc.

13. Factoring: Banks are premitted to take up factoring by floating susidiaries. Factoring is a new type of service which banks can provide. it is a device by which book debts are quickly realised through outright sale of accounts receivable to a financial intermediary (or a bank’s subsidiary) called the ‘factor’. The RBI has alread accpeted factoring in principle and banks may float subsidiaries to take up factoring. SBI and Canara Bank are the only two banks which have set up seperate subsidiaries exclusively for undertaking factoring services.

14. Off-Shore Banking : Many banks now have an international dimension in the form of off-shore or overseas banking. The operation of off-shore banking is truly international business in which banks and management groups of many countries participate. Ninety seven branches, including off-shore branches and mobile agencies of nine Indian commercial banks which include eight public sector banks and one private sector bank were operating in foreign countries as on 31st March, 1996. These branches are spread over 25 countries and specialise in vairous areas of international banking including financing of foreign trade.

15. Customer Services : A number of measures have been taken to improve the quality of customer services offered by the banks to depositors and borowers. Important among them are given as follows :

(i) About 1400 branches have been fully computerised till June 1996.

(ii) Facilities like pass book printing, self-service terminals for customers, termainals at customers' places, etc., have been started in many of the branches.

(iii) Efforts are on to conduct SWIFT (Society for Worldwide Interbank Financial Telecommunication) training courses for the Indian Banking community on regular basis.

(iv) In 1997, the Shared Payment Network System (SPNS) was started at Mumbai. It is proposed to extend this network to other cities.

(v) RBI launched the Electronic Clearing Services (ECS) in April 1995 at Mumbai and Chennai. Once this system is made available across the country, it will reduce the number of physical instruments that pass through the traditional clearing system.

(vi) RBI has also started the Electronic Funds Transfer (EFT) between Mumbai and Chennai for retail customers.

(vii) Banks are making an attempt to evaluate services rendered in terms of the expectations and requirements of the customers and to redress customer complaints.

(viii) Customer service audit are being conducted periodically to ensure meaningful implementation of Goiporia Committee Recommendations.

16. Banking Ombudsmen Scheme : Banking Ombudsmen Scheme was announced in June 1995 to provide quick and inexpensive facility to resolve customers' grievances. Eleven ombudsmen are functioning in the country. They hear and redress those grievances of customers which have not been resolved to their satisfaction within a stipulated period of two months. The complaints can fall into two areas : (a) deficiency in bank services like non-payment or delay in collection, handling of cash and currency, non-adherence to working hours, complaints from NRI and exporters (b) complaints concerning loans and advances relating to delay in sanction non-observance of RBI directions on interest rates.

17. Service Area Approach : In 1988, the RBI has started the service area approach for rural lending. This approach refers to a system of assigning special areas to each bank branch in which it can concentrate for productive lending and thus contribute to the development of the area.

CONCLUSION

During the last three decades since nationalisation in July 1969 Indian commercial banks have transformed themselves beyond recognition. Their major business before 1969 was to finance trade and industry. in accordance with the national plans, policies and priorities, banks have now taken up major responsibilities for developing and diversifying the Indian economy. They have come in a big way to help agriculture and neglected sectors. The need for avenues for profits have made them enter new fields of activity such as mutual funds, portfolio management, merchant banking, leasing and housing finance. They can be expected to diversify their functions and adopt new technologies.

Undoubtedly, the commercial banks in India have made phenomenal pogress after nationlisation. But, the critics not only point out various inadequacies and limitations of public sector banks, but also express fears about the dangers of nationlisation. Various defects of commercial banking system in India, particularly, after nationalisation of banks are discussed below :

1. Criticism by Estimates Committee : The Estimates Committee of Lok Sabha (1975) headed by Mr.R.K.Sinha has expressed dissatisfaction over the working of nationalisation banks. The Committee is of the view that nationalised banks have largely failed in achieving the main objectives of bank nationalisation, particularly, granting of loans to the priority sectors and removing regional disparities through developing banking facilities in backward areas.

2. Insufficient Help to Priority Sectors: In spite of much increase in the loans advanced to the priority sectors, the total help is not sufficient for the large size of these sectors. The rate of increase in the advances to the priority sectors which was rapid in the initial years of post-nationalisation period, has slowed down in the later years. The main reason for this slow progress was that, on the one hand the bank officials were not imbued with the new objectives of banking and, on the other hand, they were more worried about the unsatisfactory recovery performance.

3. Inadequate Facilities in Rural Areas : No doubt, much progress has been made in expanding bank branches in respect of bank expansion, deposit mobilisation and credit expansion in rural areas. But, it is not adequate to meet the financial needs of the population living in the rural areas. The magnitude of the problem is clear from the fact that at present only about 5% villages are covered by the commercial banks directly or indirectly. The stipualted deposit-credit ratio of 60% has not been achieved in the rural areas.

4. Regional Imbalances : Though the overall expansion in the bank branches has taken place in the country, their expansion is not equitably distributed among the different states. According to the Reserve Bank's reports, about half of the banking institutions concentrate in the two regions, i.e., southern and westen region comprising five states, namely, Maharashtra, Gujarat, kerala, Tamil Nadu and karnataka. On the other hand, the states like Assam, Jammu and Kashmir, Manipur, Nagaland, Orissa, Tripura, Uttar Pradesh and West Bengal still continue to remain bank-deficient states.

5. Insufficient Deposit Mobilisation : Deposit good progress on the deposit mobilisation front, much remains to be done. Deposit mobilisation by the public sector banks has been about 16 to 17% per annum since nationalisation. On the other hand, it has been found that the foreign banks and the smaller private banks have received much greater increases in deposits. The fact is that with the increase the total savings in the country, there still exists a larger scope for expansion of deposits.

6. Problem of Liberal Credit Policy: Although liberal credit policy is necessary for providing financial support to the weaker sections of the rural community, but such a policy may prove harmful for stability of the banking system. The experience of the nationalised banks has shown that these banks are now facing the problems of heavy overdue loans and economically unviable branches.

7. Sound Principles Ignored: Normally, the growth of credit should go hand in hand with growth of deposit mobilisation. But in the initial years of nationalisation, the credit expansion of banks was

about 24% as compared to the deposit expansion of about 17%. This was an unwise and risky trend. Later on, however, the credit expansion has been proportionate to the expansion in deposits.

8. Low Profitability: A major defect of banking after nationalisation is that the nationalised banks are either operating under losses or experiencing falling dividends. The profits of the commercial banks, which were quite high during fifties and sixties, have declined considerably in the post nationalisation period. Low profitability is caused by two types of factors: (a) the factors which push up costs, such as, inefficiency, bureaucratic attitude, increasing expenditure on bank staff, expansion of branches absence of effective cost control measures, etc.; and (b) the factors which reduce bank earning such as advances to the priority sectors at concessional rates, large overdue because of non-return of loans, increase in statuary liquidity ratio and cash reserve ratio, etc.

9. Low Efficiency: Nationalisation has created bureaucratic attitude in the functioning of banking system. Lack of responsibility and initiative, redtapism, inordinate delays are common features of nationalised banks. As a consequence, the efficiency of these banks has reduced.

10. Political Pressure : Political interference also disturbs the smooth working of the nationalised banks. Political pressure in the granting of loans to particular parties, the selection of personnel, opening of branches, etc. creates difficulties for these banks.

The present working and future prospects of the Indian banking system can be summed up as follows:

i. Since nationalisation, the banking industry in the country has made significant progress and now provides banking facilities throughout the country.

ii. The public sector banks have played an important role in mobilising savings and extending credit increasingly in favour of the rural areas and weaker sections of the society.

iii. In spite of the progress made by the banking institutions, the main objective of nationalisation, i.e., “to control the heights of the economy and to meet progressively, and serve better the needs of development of the economy,” has not yet been achieved. Banking facilities are still inadequate to cover all the rural and unbanked areas; regional imbalances still persist; the credit needs of priority sectors and weaker sections of the society are not sufficiently met.

iv. The banking industry in India also suffers from certain other serious problems such as growing inefficiency, alarming overdues, low profitability, political interference, etc.

v. After achieving adequate geographical coverage, the commercial banking system should now aim at consolidating the gains made so far. Consolidation implies –

(a) strengthening of banks’ structures , training, house keeping, internal procedures and systems;

(b) improving the quality of loan appraisals and loan assets;

(c) providing better consumer service;

(d) raising profitability; and

(e) adopting policies and measures to bring about all round improvement in banking operations.

vi. Future of the banking system in India depends upon

(a) adopting greater sophistication, modern work technology and innovation;

(b) involving new and growing areas of business; and

(c) increasing contacts with international banking and capital markets.

3.4 TERMINOLOGY

1. Money Market : Money market refers to the institutional arangements which deals with the short term funds.

2. Consortium Approach : More tha a bank provides finance a single borrower requiring larger credit.

3. Mutual Funds : Mutual Funds are either open-ended or close-ended financial intermediaries which gets their resources by selling shares.

4. Off-shore Banking : Off-shore banking is of international business in which banks and management groups of many countries participate.

3.5 Self Assessment Questions

Five Marks Questions

1. Mutual Funds.

2. Merchant Banking.

3. Creidt Card Facility.

4. Off-shore Banking.

5. Retail Banking.

6. Factoring.

Ten Marks Questions

1. Explain the arguments for and against nationalisation.

Twenty Marks Questions

1. Explain the achievements of banks after nationalisation.

3.6 REFERENCE BOOKS

Banking and Financial System	A.V.Ranganadha Chary & R.R.Paul.
Banking and Financial Sysem	D.M.Mithani & E.Gordon.
Indian Economy	Ruddar Datt and KPM Sundaram.

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Lesson - 4

BANKING SECTOR REFORMS

4.0 OBJECTIVES

After going through this lesson student can know about

→ Need of reforms in banking sector.

→ Narasimham Committee, 1991 - observations and suggestions

→ Narasimham Committee, 1998 - observations and Suggestions

→ Innovations in Banking Sector - Electronic Banking, ATM's and Credit cards, Debit Cards, etc.

Structure

4.1 Introduction - Need for banking secotr reforms
4.2 Development of banking after nationalisation - identified by the Narasimham Committee
4.3 Problems and Constraints of the banking system
4.4 Recommendation of the Narasimham Committee, 1991
4.5 Reform of Banking Sector (1992-2004)
4.6 Committee on Banking Sector Reforms (1998)
4.7 Evaluation of Narasimham Report (1998)
4.8 Structural changes in Banking Sector
4.9 Merchant Banking
4.10 Electronic Banking
4.11 Internet Banking
4.12 Off-shore Banking
4.13 Terminology
4.14 Self Assessment Questions
4.15 Reference Books

4.1 INTRODUCTION

India had witnessed a phenomenal expansion in the geographical coverage and functional spread of our banking and financial system since bank nationalization in 1969. Despite impressive quantitative achievements in resource mobilization and in extending the credit reach, several distortions had, crept into the banking and financial system. As a result, productivity and efficiency of the system had suffered; its portfolio quality had badly deteriorated and profitability had been eroded. Several public sector banks and financial institutions had become weak financially and some public sector banks had been incurring losses year after year. Their customer service was poor, their work technology outcoded and they were unable meet the challenges of a competitive environment. It was under these circumstances that the Government of India set up a High Level Committee with Mr.M.Narasimham, a former Governor of the Reserve Bank of India as Chairman to examine all aspects relating to the structure, organization, functions and procedures of the financial system. This Committee on the Financial System submitted its report in November 1991 and many of its recommendations proved to be controversial.

4.2 DEVELOPMENT OF BANKING AFTER NATIONALISATION - Identified by Narasimham Committee

The Narasimham Committee (1991) was primarily interested in improving the financial health of public sector banks and development financial institutions (DFIs), so as to make them viable and efficient and meet fully the emerging needs of the real economy. The basic approach of the Committee was that greater market orientation would strengthen the financial system and thus improve its efficiency.

The Narasimham Committee (1991) acknowledged the spectacular success of the public sector banks since the top banks were nationalized in July 1969.

(a) massive branch expansion, particularly in rural areas;

(b) expansion in the volume of deposits - bank deposits now constituted two-fifths of financial assets of the household sector in 1991.

(c) rural penetration of the banking system - rural deposits as a proportion of total deposits had increased from 3 per cent to 15 per cent;

(d) diversion of an increasing portion of the bank credit to priority sectors, viz. agriculture, small industry transport, etc. - the priority sector credit had gone up from 14 per cent to 41 per cent between 1969 and 1991;

(e) increase in deposit and borrowal accounts - over 300 million deposit accounts in the country and over 35 million borrowal accounts (there were barely 4,00,000 borrowal accounts in 1969); and

(f) more involvement in the relatively underbanked states - the expansion of priority sector lending and the emphasis on area approach has almost evened - out regional disparities and the concentration of banking business was relatively less in 1991.

While the banking system in India had recorded spectacular progress since nationalization, it had also suffered serious decline in productivity and efficiency and consequent erosion in profitability. Narasimham Committee (1991) pointed out that directed investment and directed credit programme were the two major causes for this state of affairs.

4.3 PROBLEMS AND CONSTRAINTS OF THE BANKING SYSTEM

Maintenance of adequate liquid assets is a basic principle of sound banking. Hence commercial banks in India were required by the Banking Regulation Act, 1949 (under section 24) to maintain liquid assets in the form of cash, gold and unencumbered approved securities - that is, government securities and government guaranteed securities - equal to not less than 25 per cent of thei total demand and time deposit liabilities. This requirement is known as statutory liquidity ratio (SLR). The RBI was given the powrr to change the minimum ratio. Accordingly, RBI raised SLR from 25 per cent to 30 per cent (in November 1972) and further gradually to 38.5 per cent by 1991. RBI had stepped up the SLR for two reasons.

(a) A higher SLR forced commercial banks to maintain a larger proportion of their funds in government securities and government guaranteed securities (of public sector financial institutions) and thus reduced the capacity of commercial banks to grant loans and advances to business and industry.

(b) A higher SLR diverted bank funds away from loans and advances to industry and trade, to investment in government securities, this was said to have an anti-inflationary effect.

The Narasimham Committee(1991) argued that the high SLR adversely affected profitability of the banks.

Cash Reserve Ratio (CRR)

Under the Reseve Bank of India Act, 1934, every scheduled bank has to keep certain minimum cash reserves with the RBI - initially it was 5 per cent against demand deposits and 2 pe cent against time deposits. By an amendment of 1962, RBI was empowered to vary the cash reserve ratio between 3 per cent to 15 per cent of the total demand and time deposits. Generally, CRR is changed only occasionally by central banks but this was not so in India. The CRR had been changed many times, as part of the overall strategy of demand management. By 1991, the CRR was raised to the statutory maxium of 15 per cent on the average.

Directed Credit Programme

A major objective of bank nationalisation in July 1969 was to extend the rach of bank credit to agriculture and other neglected sectors, designated as “priority sectors”. In course of time, the Government added more categories of sectors like the export sector, food pocurement operations, etc., for the special attention of scheduled banks. Banks were asked to make a success of these directed credit programmes. They were also told to shift form security-oriented credit to purpose-oriented credit.

Political and Administrative Interference

According to the Narasimham Committee (1991), the most serious damage to the public sector banks was the political and administrative interference in credit decision-making. The Narasimham Committee 1991, stated: “The intended socially oriented credit in the process, degenerated into irresponsible lending”. To this was also the case in the distribution of IRDP loans among the poor and the economically weak in our rural areas. As a result public sector banks had sufered badly: lower income, inadequate provisioning for bad debt, locking of credit from more productive uses and erosion of profitability.

Subsidizing of Credit: Low rate of Interest

The Government of India managed to appropriate bank funds under the SLR scheme at low rates of interest for its own use. At the same time the Government of India stipulated that bank lending to the priority sector and IRDP lending, would also be at concessional rate of interest, banks were forced to charge very high rates of interest on borrowers from industry and trade.

According to the Narasimham Committee 1991, there was actually no need for interest subsidy which only reduced to ability of banking system to build its strength and to extend the coverage of bank credit even wider.

Mounting Expenditure of Banks

We have explained above the squeeze on profitability of banks from the side of revenue.

From the expenditure side, public sector banks were saddled with mounting expenditure. The Narasimham Committee 1991, mentioned the following points:

(i) Phenomenal increase in branch banking, without any relation to demonstated need and potential viability.

(ii) The lines of command and control tended to weaken central office supevision, internal inspection and audit, and increased unrecounciled inter-branch and inter-bank entries.

(iii) Rapid growth in staff in number and in accelerated promotions: this had led to detrioration in the quality of manpower, over-manning at all levels, etc.

(iv) Role of trade unions: They had contributed increasingly to the restrictive practices regarding promotions, transfers, discipline and work culture, mechanisation and computerisation, etc. Remunerations and their upward revisions were not related to productivity of either individual banks or to the system. inefficient customer service and declining labour productivity were the consequences.

(v) Extension of the coverage of bank credit to agriculture and small industry where the unit cost of administering the loans was high; besides, this type of credit was at low rates of interest, as mentioned earlier.

Thus, despite impressive quantitatie acheivements in resource mobilisation and in extending the credit reach, several distortions had, over the years, crept into the banking system. Several public sector banks had become weak financially and were unable to meet the challenges of a competitive environment.

4.4 RECOMMENDATION OF THE NARASIMHAM COMMITTEE, 1991

The Narasimham Committee’s recommendations were based on the fundamental assumption that the resources of the banks come from the general public and were held by the banks in trust and that they were to be deployed for maximum benefit of the depositors. This assumption automatically implied that even the Government had no business to endanger the solvency, health and efficiency of the nationalised banks under the pretext of using banks resources for economic planning, social banking, poverty eradication, etc. Besides, the Government had no right to get hold of the funds of the banks at low rates of interest and use them for financing its consumption expenditure - paying the salary of the employees, for example - and thus defraud the depositors. The Narasimham Committee recommendations were aimed at:

(i) ensuring a degree of operational flexibility,

(ii) internal autonomy for the public sector banks in their decision-making process; and

(iii) greater degree of professionalism in banking operations.

A. On Directed Investment

The Narasimham Committee 1991, gave two important recommendations as regards SLR and CRR.

(a) Statutory liquidity requirements (SLR). The Government should give up immediately the practice of using SLR as a major instrument of mobilising funds for the Government and the public sector financial institutions. The Narasimham Committee, (1991) recommended that the government should reduce the SLR from the present 38.5 per cent of the net demand and time liabilities of banks to 25 per cent over the next five years. A reduction in the SLR levels would leave more funds with banks for allocation to agriculture, industry, trade, etc.

The Committee further recommended that the Government borrowing rates should be progressively marked-related and that these higehr rates would help banks to increase their income from their SLR investments.

(b) Cash Reserve Ratio (CRR). The Narasimham Committee, (1991) recommended that RBI should rely on open market operations increasingly and reduce its dependence on CRR. The Committee, proposed that

(i) CRR should be progressively reduced from the present high level of 15 per cent to 3 to 5 per cent, and

(ii) RBI should pay interest on impounded deposits of banks above the basic minimum at a rate of interest equal to the level of banks' one year deposits.

These recommendations would reduce the amount of idle cash balances kept by the banks with RBI under CRR and release the amount for more productive and remunerative purpose. Besides banks would also earn more income from the cash balances they kept with RBI.

B. On Directed Credit Programmes

The Naraimham Committee, 1991 recommended that the system of directed credit programmes should be gradually phased out. For one thing, agriculture and small industry had already grown to a mature stage and they did not require any special support. For another, two decades of assistance with interest subsidy were enough and therefore, concessional interest rates could be dispensed with. The Committee had argued that the system of directed credit should not be a regular programme but should be a case of extraordinary support to certain weak sections of the economy. Besides, it should be temporary and not a permanent one.

The Committee also proposed that the concept of priority sector should be redefined to include only the weakest sections of the rural community such as marginal farmers, rural artisans, village and cottage industries, tiny sector, etc. The directed credit programme for this "redefined" priority sector should be fixed at 10 per cent of the aggregate bank credit. The system should be reviewed after a period of three years or so to assess the need to contiue or terminate the progrmme as also the stipulation of the concessional rate of interest. The social purpose of bank credit should be to enhance small industry. The Narasimham Committee (1991) emphasised in this connection: "The postulates of social banking need not clash with sound banking."

C. On the Structure of Interest Rates

The Narasimham Committee, 1991 recommended that the level and structure of interest rates in the country should be broadly determined by market forces. Al controls and regulations on interest rates on lending and deposit rates of bank and financial institutions on debentures and company deposits, etc., should be removed. Concessional rates of interst for priority sector loans of small sizes should be phased out; and subsidies in IRDP loans should be withdrawn.

The Committee, further proposed that RBI should be the sole authorit to simplify the structure of interest rates. The Bank rate should be the anchor rate and all otehr interest rates shoul dbe closely linked to it.

D. On Structural Reorganisation of the Banking Structure

To bring about greater efficiency in banking operations, the Narasimham Committee, (1991) proposed a substantial reduction in the number of public sector banks through mergers and acquisitions. According to the Committee, the broad pattern should consist of:

(a) 3 or 4 large banks including the State Bank of India which could become international in character;

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

(c) Local banks whose operations would be generally confied to a specific regions; and

(d) Rural banks including RBs whose operations would be confined to the rural areas and whose business would predominantly engaged in financing of agriculture and allied activities.

Since the country had already a network of rural and semi-urban branches, the Narasimham Committee, 1991 proposed that the present system of licensing of branches with the objective of spreading the banking habit should be discontinued. Banks should have the freedom to open branches purely on profitability considerations.

The Committee wanted the Government to make a positive declaration that there would be no more nationalisation of banks. RBI should permit the setting up of new banks i the pivate sctor, provided they confirm to the minimum start-up capital and otehr requirements. There should be no difference in the treatment between public sector banks and private sector banks.

The Narasimham Committee 1991 recommended that the Government should allow foreign banks to open offices in India either as branches or as subsidiaries. They should conform to or fulfill the same or similar social obligations as the Indian banks. Foreign banks and Indian banks should be permitted to set up joint venture in regard to merchant and investment banking, leasing and other newer forms of financial services.

Other Recommendations Relating to the Banking System

The setting up of Assets Reconsruction Fund (ARF). nationalised banks and Development Finance Institutions (DFIs) were burdended with sub-standard, doubtful and loss assets known as non-performing assets (NPAs). Narasimham Committee recommended the setting up of the Assets Reconstruction Fund (ARF), to take over from the nationalised banks and financial institutions, a portion of their bad and doubtful debts at the discount. All bad and doubtful debts of banks and financial institutions were to be transfered in a phased manner to ensure smooth and effective functioning of the ARF. Thsi arrangement would help the banks and the financial institutions to take off bad and doubtful debts from their balance sheets and recycle the funds realised through this process into more productive uses.

Remove the Duality of Control. The Narasimham Committee, 1991 recommended that the present system of dual control over the banking system between RBI and the banking Division of the Ministry of Fiannce should end immediately and that RBI should be the primary agency for the regulation of the banking system.

Free and Autonomous Banks. The Narasimham Committee, 1991 recommended that the public sector banks should be free and autonomous. Every bank should go for a radical chane in work technology and culture, so as to become competitive internally and to be in step with wide ranging innovations taking place abroad. RBI should examine all the guidelines and directions issued to the banking system in the contex of the independence and autonomy of banks. Finally, the appointment of the Chief Executive of a bank (Chairman-cum-Managing Director) should nto be based on political considerations but on professionalism and integrity and should be made by an independent panel of experts and not by the Government as at present.

The Narasimham Committee, 1991 directly blamed the Government of India and the Finance Ministry for the sad state of affairs of the public sector banks. these banks were used and abused by the Finance Ministry of the Government of India, the bank officials and the bank employee and the bank unions.

The recommendations of the Narasimham Committee, 1991 were revolutionar in many respects and were naturally opposed by the bank unions and the leftist political parties.

4.5 REFORM OF BANKING SECTOR (1992-2004)

Despite still opposition from bank unions and political parties in the countr, the Government of India accepted all the major recommendations of Narasimham Committee and started implementing them straight-away:

(1) Statutory liquidity ratio (SLR) :On incremental net demand and time liabilities (DTL) has been reduced from 38.5 per cent 25 per cent and SLR on outstanding net domestic demand and time liabilities were reduced gradually form 38.5 per cent to 25 per cent in October 1997; this was the minimum stipulated under section 24 of Banking Regulation Act, 1949.

(2) Cash Reserve Ratio (CRR): The incremental cash reserve ratio (IC) of 10 per cent was abolished. But RBI could not reduce CRR immediately. When conditions eased and money growth started slowing down since 199-96, RBI reduced CRR gradually from 15 per cent to 5.5 per cent in December 2001. The pupose of reducing CRR was to release funds locked up with RBI for lending to the industrial and other sectors which were starved of bank credit.

(3) Interest Rate Slabs : Were gradually reduced from 20 to 2 by 1994-95. The important changes in interes rates since 1991-92 are as follows:

(a) Interest rate on domestic term deposits has been decontrolled;

(b) Rate of interest on bank loans above Rs. 2 lakhs has been fully decontrolled.

(c) The interest rates on deposits and on advances of all co-operative anks have been deregulated.

The purpose of deregulation of interest rate on the high slab of bank advances was to stimulate heathly competition among the banks and encourage their operational efficiency. It would also help banks better adjust their lending rates to the track record and risk perception with regard to their customers.

Scheduled commecial banks have now the freedom to set interest rates on their deposits subject to minimum floor rates and maximum ceiling rates.

(4) Prudential norms: Have been started by RBI as part of the reformative process. The purpose of prudential sstem of recognition of income, classification of assets and provisioning of bad debts is to ensure that the books of the commercial banks reflect their financial position more accuratel and in accordance with internationally accepted accounting practices. These help in more efective supervision of banks.

Prudential norms required banks to make 100 per cent provision for all non-performing assets (NPAs) As funding for this purpose was placed at Rs.10,000 crores, it was phased over two years. Banks had to make at least 30 per cent provision against doubtful and bad debts during 1992-93 and the balance 70 per cent in 1993-94.

(5) Capital adequacy norms: Were fixed at 8 per cent by RBI in April 1992 and banks had to comply with them over a three year period. By end March 1996, all public secotr banks had attained capital to risk weighted assets ratio of 8 per cent. The full norm of 8 per cent was also attained by foreign banks in India and by some Indian banks.

The prudential guidelines and the new capital adequacy norms expect scheduled commerical banks to make large provisiosn amounting to over Rs.14,000 crores for bad and boubtful advances in their portfolio. As the resulting losses would erode the already inadequate cpaital of the banks, the viabilit and financial health of the banking system was sought to be potected by a capital contribution of Rs.5,700 crores by the Union government in the budget for 1993-94 and anotehr Rs.5,600 crores in the budget for 1994-95 for recapitalisation of the less profitable nationalised banks. The reciepient banks were required to draw up plans to become viable ove a period of two to three years.

A new capital framework wa introduced for Indian scheduled commercial banks based on the Basle Committee recommendations presening two tiers of capital for the banks:

(a) Tier I or core cpital, considered the most permanent and readily availabel support against unexpected losses, include paid-up capital, statutory reserves, share premium and capital reserve; and

(b) Tier II capital consisting of undisclosed reserves, fully paid-up cimulative prepetual prefernce shares, revaluation reseves, general provisions and loss reserves, etc.

It was also prescribed that Tier II capital should no be more than 100 per cent of Tier I capital.

(6) Access to Capital market : The government of Indian has amended the Banking Companies (Acquisition and Transfer of Undertakings) Act to enable the nationalised banks to access the maket for capital funds through public issues, subject to the provision that the holding of the Central Government would not fal below 51 per cent of the paid-up capital.

SBI was the first to raise through public issue over Rs.1,400 crores as equity, and Rs.1,000 cores as bonds. RBI shareholding of SBI is now 67 per cnet as against 99 per cent earlier. SBI Act has also been amended to allow 10 per cent voting rights to the shareholders. The Oriental Bank of Commerce raised Rs.360 crores during 1994-95 through a public issue. Other nationalised banks have also approached or are planning to approach the capital market.

(7) Feedom of Operation: Scheduled Commecial banks have now been given freedom to open new branches and upgrade extension counters, after obtaining capital adequate norms and prudential accounting standards. They are also permitted to close non-viable branches other than in rural areas. Bank lending norms have been liberalised and banks have been given freedom to decide levels of holding of individual items of inventories and recievables.

(8) New Private Sector Bansk: Ten private sector banks have already started functioning. These new private sector banks are allowed to raise capital contribution from foreign institutional investors upto 20 per cent and from non-resident Indians (NRIs) upto 40 per cent.

(9) Local Area Banks: In the 1996-97 budget, the Government of India announced the setting up of new private local area banks (LABs) with jurisdiction over three contiguous districts. These banks will help in mobilising rural savings and in channelling them into investment in local areas. The RBI has issued guidelines for setting up such banks in 1996 and gave its approval “in principle” to the setting up of several LABs in the private sector. Of these, RBI had issued licences to 5 LABs, located in Andhra Pradesh, Karnataka, Rajasthan, Pubjab and Gujarat. These LABs have commenced business.

(10) Supervison of Commerical Banks: Supervision of commericla banks is being tightended by RBI, specially after the securities scam of 1992. RBI ahs set up a Board of Financial Supervision with an Advisory Council under the Chairmanship of the Governor to Strengthen the supervisory and surveillance system of banks and financial institutions. RBI has also established banks and financial institiotions. RBI has also established in December 1993 a new department known as Department of Supervision as an independent unit for supervision of commercial banks and to assist the Board of Financial Supervision.

The Working Group under Mr.S.Padmanabhan, set up to review the system of on-site supervision of banks, has recommended extensive changes in bank inspection which include target appraisal of major portfolios and control system and a discriminatory approach to supervision and inspection that distinguishes sound banks from problem banks.

(11) Recovery of debts: The Government of India passed “Recovery of Debts due to banks and Financial Institutions Act, 1993” in order to facilitate and spend up the recoevery of debts due t banks and financial institutions. Six Special Recovery Tribunals ahve been set up at Calcutta, New Delhi, Jaipur, Ahmedabad, bangalore and Chennai to facilitate quicker recoveries of loan arrears within six months and an Apellate Tribunal has also bee set up in Mumbai.

Perspectives

The banking reforms since 1992, based on the recommendations of Narasimham Committee, 1991 aimed at transforming the highly regulated and directed public sector banking system into one characterised by openness, competition, prudential and supervisory discipline. In the Reort on Trend and progress of Banking in India: 1992-93, RBI states clearly “Commercial Banks thhus need to become conscious that they are entering a challenging environment and will have to redefine their position within the financial industry. new ways and methods will have to be determined in order to successfully respond to the challenges particularly, the growing demands from customers for high quality service.”

This will necessitate “commercial orientation” of all banks especially public sector banks; and they will have to:

(a) provide beter returns on the savings of the investors;

(b) adopt strategies to generate additional revenues;

(c) reduce emerging financial risks through the creation of new services;

(d) improve income to cost ratio and enhance operational effectiveness; and

(e) address aggressively to the problems of depressed profitability and high and growing non-performing assets (NPAs).

4.6 COMMITTEE ON BANKING SECTOR REFORMS (1998)

The Finance Ministry of the Government of India appointed Mr.Narasimham as chairman of one more Committee; this time it was called the Committee on the Banking Sector Reforms. The Committee was asked to "review the progress of banking sector reforms to date and chart a programme on financial sector reforms necessary to strengthen India's financial system and make it internationally competitive." The Narasimham Committee on the Banking Sector Reforms submitted its report to the Government in April, 1998. Thsi report covers the entire gamut of issues, ranging from capital adeuacy, bank mergers the creation of global-sized banks, recasting bank baords and revamping bank legislation. Important findings and recommendations of this Narasimham Committee (1998) are as follows:

(i) Need for a stronger banking system : The Narasimham Committee (1998) has made out a strong case for a stronger banking system in the country, especially in ther context of capital account convertibility (CAC) which would involve larger inflows and ouflows of capital and consequent complications for exchanger rate management and domestic liquidity. To handle such problems, India needs a strong and reslient banking and financial system. For this prupose, the Narasimham Committee on Banking Sector Reforms (1998) has recommended the merger of strong banks which will have a 'multiplier effect' on industry. The Committee has, however, cautioned the merger of storng and weak banks, as this may have a negative impact on the asset quality of the stronger bank. TheCommittee has also supported that two or three large Indian Banks be given international or global character.

(ii) Experiment with the concept of narrow banking: The Narasimham Committee on Banking Sector Reforms in seriously concerned witht he rehabilitation of weak public sector bakss which have accumulated a high percentage of non-paying assets (NPAs), which, in some cases were a high as 20 per cent of the total assets. The Narasimham Committee (1998) has suggested the adaption of the concept of narrow banking on rehabilitate such weak banks. narrow banking implies that the weak banks place their funds only in the short-term in risk free assets - these banks attempt to match their demand deposits by safe liquid assets. In case the concept of narrow banking is found to be non-applicable to rehabilitate weak banks, the issue of closure should be examined, according to the Committee.

(iii) Small, local banks: The Narasimham Committee (1998) has argued: "While two or three banks with an international orientation and 8-10 large national banks should take care of the needs of the large and medium corporate sector and the lager of the smaller enterprises, there will still be a need for a large number of local banks." The Committee has, therefore, suggested the setting up of small, local banks which would be confined to States or cluster of districts in order to serve local trade, small industry and agriculture. At the same time, these banks should have strong corresponding relationship with the larger national and international banks.

(iv) Capital Adequacy Ratio: The Narasimham Committee (1998) has also suggested that the Goverment should consider raising the prescribed capital adequacy ratio to improve the inherent strength of banks and to improve their risk absorption capacity. The Committee has suggested higher capital adequacy requirements for banks and the setting up of an Asset Reconstruction Fund (ARF) to take over the bad debt of the banks.

(v) Public Ownership and Real Autonomy: The Narasimham Committee (1998) has argued that Government ownership and management of banks does not enhance autonomy and flexibility in the working of public sector banks. In this connection, the Committee has recommended a review of the functions of boards so that they (the bank boards) remain responsible for enhancing shareholder value through formulation of corporate strategy.

The Narasimham Committee (1998) has considered the issue of autonomous status for the Board for Financial Supervison of RBI and the need to segregate regulatory and supevisory functions of RBI. The Committee expressed the need for RBI to maintain an arms length from those being regulated and hints at the need for withdrawing RBI nominee rom bank boards. The Committee states: "Regulation should be concenred with laying down procedural and disclosure norms and sound procedures and ensure adherence to these and not get into the day-to-da management of banks".

(vi) Review and update Banking Laws: The Narasimham Committee (1998) has suggested the urgent need to review and amend the provisions of RBI Act, banking Regulation Act, State Bank of India Act, Bant Nationalisation Act, etc. so as to bring them in line with the current needs of the banking industry.

Other recommendations relate to the need for computerisation process in public sector banks, professionalisign and depoliticising bank bords, review of recruitment procedures, trainign and remuneration policies etc.

4.7 EVALUATION OF NARASIMHAM REPORT, 1998

Really speaking, there was no purpose in setting up the second Narasimham Committee on Banking Sector Reforms even before the decade has elapsed for the full implementation of the First Committee Report (submitted in 1991). As one critic has commentated; "Barring, that is, a stray recommendation here or there like the categorically rejection of the merger of weak with srong banks and the suggestion to try out narrow banking, as far as all other issues are concerned, whether it is organisation, restructuring, freeing bank boards from day - to - day management and interference segregating the regulatory and supervisory role of the Reserve Bank of India (RBI), it is like watching an action replay of the earlier report." We can attempt a comparison of some of the major recommendations of the 1991 and 1998 reports of the Committees presided over by Mr.Narasimham.

In simple terms, the setting of the Narasimham Committee of Banking Sector Reforms was clearly, the brainwave of the officials of the Banking Division of the Finance Ministry who have actually no real work to do. it is worth noting here that two members of the Narasimham Committee (1991) clearly recommended the closing down of the Banking Division of the Finance Ministry as redundant and unnecessary and that all matters pertaining to the banking sstem should be the responsibility of only one authority viz., RBI. Obviously, this recommendation was not accepted by the Finance Ministry.

4.8 STRUCTURAL CHANGES IN BANKING SECTOR

The structure of banking industry in 1991-92 is also as follows : (i) 27 Public sector banks including State Bank and 7 associate banks and 19 nationalized banks - (ii) 34 private sector banks; (iii) 42 foreign banks and (iv) 196 RRBs making a total of 299. The number of branch offices of all these put together increased from 8260 in 1969 to 60,650 in 1996-97 of which 54% of branches were in rural and Semi-Urban areas. The population per branch office decline from 65,000 to about 14,000 during this period.

1. Private Sector Banking

The Narasimham Committee (1) which pleaded for competition in the banking industry urged the Government to allow private and foreign banks to enter the industry. Consequently g uidelines for the establishment of private banks was issued in January, 1993. The guidelines aim at ensuring that the new entrants are financially viable and technologically uptodate. The paid-up capital of the new banks shall not be less than Rs.200 crore which shall be raised to Rs.300 crores within 3 years after the commencement of business. The stake of the promoters shall not be less than 40%. Furthermore, the banks should be financially viable and they should avoid practices such as unfair competition and concentration of credit, cross holding with industrial groups etc. Accordingly, 9 banks were setup in the private sector, including some by development financial institution. Promiment among them are ICICI Banks, GTB, HDFC and IDBI Bank. During 1999-2000, one of the NPBs, namely Times Bank merged with another NPB the HDFC Bank, thus reducing the number of new banks to 8. Later, the Bank of Maduri Ltd., merged with ICICI Bank in 2001. In result the number of private sector banks in May, 2003 is 32.

Another interesting development is that some of the old private sector banks which are financially weak were taken over by public sector banks. Barielly Corporation Bank Ltd., merged with bank of Baroda in 1999 and Benars State bank again with Bank of Baroda in 2002. The Nedungadi Bank, another small Private Sector bank merged with the Punjab National Bank.

2. Public Sector Banks - Disinvestments

The financial health of public sector banks deteriorated overtime due to the implementation of Government programmes mostly on political considerations. To arrest the deterioration in the fianncial strength and in order to enable them to satisfy new capital requirements as per international guidelines, recapitalisation was initiated in 1993 aggregating Rs.20,446 crore by the end of 1990's. There has been further infusion of cpaital as public sector bank s are allowed to approach the capital market. In December 1993 and january 1994, the SBI raised Rs.200 crore from public though the issue of equity and another Rs.1000 crore through issue of bonds. A number of public sector banks like the Bank of Baroda, Andhra Bank, Canara Bank, PNB etc. have sold shares in the capital market.

To cover budget deficits, the Government of India implemented a policy of disinvestment. Public Sector Undertakings, which were described as Temples of modern India, have been pulled down one after another. In the name of banking sector reforms a radical change in the ownership of PSBs is contemplated. In a majo rpolicy announcement the Government of India decided to reduce its stake in PSBs from 100% to 51% retaining, however, the policy parameters of public sector banks. The PSBs in the past relied on Government support to strengthen the capital base. With the Government deciding to reduce its stake, they approached the capital market for resources. The process would gather further momentum when the government's stock holding gets reduced to 33% or below. Further, there is a provision for foreign investments in PSBs to the extent of 20%. With the change in fundamentals many foreign investors are eyeing these banks as a good investment option. When the Government reduces its stake to 33%, it is likely that FDI cap may be increased to fetch better value of its holding. With evey increase in the capital base of these banks, the share of public is bound to increase.

The Government holdings in PSBs as the September 2003 varied between 57.2%(Corporation Bank) to 80% (PNB). In SBI the promoters holdings are 59.7%. The rest is held by the public, foreign investors, financial institutions, Body corporates etc. The net result of the dilution in ownership of PSBs is that these banks are becoming Joint Sector Banks.

3. Foreign Direct Investments

The Government has been pursuing an open door policy and opened the floodgates for the inflow of foreign capital in the form of FDI, investments by foreign institutional investors etc, in the banking sector too. FDIs are also permitted in Indian Banks, but it was limited to 49% fo the capital but now raised to 74% facilitating setting up of subsidiaries of foreign banks and attracting investment in private sector banks. The new private sector banks are allowed to raise capital contribution from foreign institutional investors upto 20% and from NRIs upto 40% fo their share capital. The new private sector banks are allowed to raise capital contribution from foreign instutitional investors upto 20% and from NRIs upto 40% of their share capital.

Promoters stake in Indian banks is currently limited to 49%. While issuing licenses, the RBI has instructed those promoters of private banks who held a higher holding than the prescribed limit to divest their stake and bring it down to 49%. Indian promoters argue that such discrimination may make Indian Private banks vulnerable to take over by foreign bank. It is hoped that the limit to Indian promoters holding will be raised to 74% as is done for FDI.

The increase in FDI limit in private banks will have serious repercussions to Indian interests. It will enable foreign partners to increase their stake and acquire management control over Indian banks. Of course presently there is a cap on voting rights of any person to 10% in private sector, irrespective of his shareholdings. It means that ever if an entity holds more than 10% stake in a bank, its voting rights are capped to just 10% private sector. But there is a proposal to amend the Banking Regulation Act to remove this cap. With direct foreign investment upto 74%; the so-called Indian private sector banks will become Joint Sector institutions between Indian Investor and foreign investors. If the cap on voting right is removed, the foreign investors will surely obtain management control over Indian banks.

The Indian Banks with low capital adequacy ratio will have the option to raise capital from overseas investors. Presently, Indian banks which can offer stake to foreign investors are GTB, Indus Bank and Bank of Punjab. Banks like ING Vysya and Centurion Bank may further increase the stake of foreign investors.

4. Foreign Banks' Expansion

The Narasimham Committee on Banking Sector Reforms (1998) had recommended that in addition to branches (as is the case now), foreign banks may be allowed to set up subsidiaries or Joint ventures which should be treated on a par with other private banks and be subject to same condititons with regard to branches and priority sector lending as the latter.

If higher FDI (74%) are permitted and if the cap of 10% on voting rights is removed, it will lead to mergers in the banking sector as most of the Indian Private Banks are undervalued. Since it is difficult to foreign banks to get a license and operate in India, many of them may use the takeover route to enter the Indian market.

The number of foreign banks which was 14 in 1980s increased to 42 by 2000 still confining their operations in metropolitan centers and cities. The wonderful fact is that while the number of foreign banks is more than 40, the number of Indian banks is less than 32 in private sector.

It is only recently that the regulatory environment has become conducive for foreign banks expansion. The recent acquisition by the British Multinational Bank, HSBC of a chunk of shares in the UTI Bank has a major implication for the Indian banking sector. Both the institutions claim that the purchase of shares by HSBC is simply an investment decision. The action of HSBC, however, will have far reaching implications for Indian Banking. Another Bank, Centurion Bank is in the que. The Bank of Muscat with a limited presence in India is collaboration with certain overseas equity funds is acquiring Centurion Bank, a bank with dismal performance.

These developments have one important message. For a foreign bank, the acquisition route is more cost effective way of growing in India, compared with the conventional route of starting a subsidiary or opening new branches. Despite their presence in the country from a very long time, foreign banks have remained niche players. They therefore prefer to acquire control or forming a strategic alliance with a domestic bank with a wide branch network which is relevant at a time when banks are tending more towards retail banking.

5. Mergers and Acquisitions

The pressure on capital structure is expected to triggers a phase of consolidation in the banking industry through mergers and acquisitions. As a matter of fact, the Narasimham Committee (1991) proposed structural reorganisation whcih involves a substantial reduction of public sector banks through mergers and acquisitions. It proposed the pattern of (a) 3 or 4 large banks of international character, (b) 8 to 10 national banks engaged in general or universal banking, (c) local banks whose operation to be confined to a specific areas and (d) RRBs inancing predominantly agriculture and allied activities. These proposals, if implemented, will not only lead to pulling down of Public Sector banks who have done a commendable Job of providing credit facilities to different sectors and also earned to reputation of being poor man's banks but also to the emergernce of oligopolies and monopolies.

In the past due to the eixstence of a large number of small non-viable banks, the RBI encouraged mergers of small banks and acquisition some of them by bigger ones. Consequently, the number of banks operating in the country came down from 620 in 1949 to 85 in 1969. Now, market driven mergers between private banks have been taking place. In the coming years, it is expected that the movement will gather momentum. Mergers between public sector banks and between public sector banks and private banks could be the next logical step if the market players wish to consolidate their position to remain in competition. If the process of consolidation through mergers and acquisitions gains momentum, we could see the emergence of banking structure as envisaged by the Narasimham Committee.

Opening up of the financial sector from 2005 under WTO would see a number of global banks taking large stakes and control over banks in the country. They would bring with them capital, a technology and management skills which is an advantage. The Government policy of encouraging greater flow of FDI and removal of cap on voting rights of shareholders is a pointer in this direction. Consolidation could take place through strategic alliances and partnerships also. The number of mergers and amalgamations during the period 1998-2003 is 14-five between foreign banks, two between a public sector bank and two private banks and the res tbetween Indian private banks.

The RBI has asked for more powers to regulate mergers and acquisitions. These powers are essential to prevent back door entry of undesirable promoters. The RBI likes to vet any proposal to acquire a sizable chunk of bank's shares or one to merge non-banking finance company and a bank. So far as good.

4.9 MERCHANT BANKING

Commercial banks have entered into merchant banking business. They have set up merchant banking divisions and are underwriting issues. Some of the banks have set up separate subsidiaries as offer wide range of merchant banking services. At the end of 1991, comerical banks have started their equipment leasing and merchant banking subsidiaries.

4.10 ELECTRONIC BANKING

To cutdown costs they are two courses open to banks: (i) mergers/amalgamations (ii) technology banking-electronic banking. Foreign banks are much ahead of us in introducing electronic banking. Technology is adding globalisation and integration of financial markets across the globe. Customers' expectations for new products and alternative delivery channels have been rising. Bank are under pressure to offer today, what customers would be expecting tomorrow. Thanks to innovations and spread of new technology, banks today offer the customer a choice to conduct his business across the country, over phoen or via a Computer. The Rangarajan Committee (1988) report is the first step for the introduction of computers. The Saraf Committee (1994) on Technology issues relating to payments, cheques clearing and securities settlements made several recommendation to improve the quality of service. Although several steps have been taken by the Indian Banking Industry, it still lags behind the industry in developed countries.

The delivery of bank's services to a customer at his office or home by using electronic technology may be called electronic banking. The increased use of electronic technology to meet the growing competition in banking is transforming brick and mortar banking(banking at a fixed branch premises) to electronic banking. It is anywhere and any time banking - 24 hours in a day, 7 days a week.

The delivery of banking products/ services by electronic channels may be defined as electronic banking. It started with the introduction of computers and ATM (in 1970s). The next step was telephone banking (in 1980s) and now Internet banking. The introduction of new instruments such as credit cards, ATM, retail Electronic Funds Transfer(EFT) and Electronic Clearing Services (ECS) have all helped in developing an effective, efficient and speedy payment and settlement systems. Internet banking is slowly becoming popular in India. All these constitute electronic banking.

Facets of Electronic Banking

Let us describe the facets of electronic or high-tech banking:

1. Computerisation : The first step was introduction of computers in branches, controlling offices and head office of banks. In the first phase of computerization spanning five years ending 1989, Indian banks had installed 4776 Automatic Ledger Posting Machines (SLPM) at the branch level, 233 mini computers at the regional/controlling office levels and trained over 2000 programmers/ system personnel and over 12000 data entry terminal operators. From the initial start in the area of computerisation, banks today travelled a long journey and introduced diverse products and delivery channels to meet the ever increasing expectations of customers. The new initiatives have brought to the customer much demanded convenience or anywhere and anytime banking. These facilitated the transition to universal banking. Some of the major developments in the are:

2. Telephone Banking : (Home Banking) It is fast becoming one of the most popular products. Customers can perform a number of transactions from their home or office, in fact from anywhere they have access t oa phone. Customers can check balances and statement information, transfer funds from one account to another, pay certain bills and order statement or cheque books.

3. ATM : The use of computers was extended to improve customer service in a direct way. The introduction of Automated Teller Machines (ATMs) imparted flexibility to bank customes. The traditional branch model of a bank giving place to alternative delivery channel through ATM and PC banking. ATM is popularlyknown as any time money machine. Each bank instals ATMs in important places, markets, railway stations and at different points in cities and towns. Whenever the customer wants get Fast Cash, withdrawal or cash depoist, he can go to an ATM spot and transact his business. The ATMs located at different spots are linked to the host computer in the bank. The transaction are in real time; that is, instantaneously booked to customers account. ATMs or customer activated terminal provide self-service banking.

Shared Payment Network System(SPNS) of ATMs : Since ATMs are expensive machines, bank may share the cost with other banks or share the use of ATMs belonging to other banks, that are a part of network. 'Swadham' ATM network in Mumbai is an example of this service. It is in operation since 1997. It provides round the year electronic banking service to the customers of 28 member banks in Mumbai. It is started at the behest of the Indian Banks Association.

4. Personal Computer Banking : It is a new electronic banking product. Personal Computer Banking enables corporate clients to have access to their accounts through a dial-up connection with their bank's data base. Customers can perform all transactions that are available on telephone banking. They, in some cases, can down load information and process it in their own financial management software.

5. Network Banking or Online Banking : Customers are provided access to banks via internet. Coupled with computerisation of the branch network of each bank, the Reserve Bank of India suggested to all banks to network their branch offices for intra-bank connectivity for addressing the twin issues of intra-bank funds transfer and transmission of critical MIS information between branches and controlling offices. Intra-bank connectivity will ensure the funds department is connected to the controlling office on the one hand and with large business centres on the oher.

6. Electronic Funds Transfer (EFTs) : This is an electronic debit of the customer's account at the point of sales of goods and services in the market. Bank customers can buy goods and services in shops without carrying cash. The customer uses his credit/debit card issued by the bank for his purchases. The system works by keeping in a transaction by using PIN(Personal Identification Number) and thereafter swipes of card through a card reading device in the shop to enable the system to capture the transactions. If the transaction is permitted (availability of limit of funds on the credit/debit card) the branch gives a debit in the customers account. The introduction of debit cards and credit cards helped both consumers and retailers to free from cash handling.

The development and use of communication network has helped the banking industry to gain in terms of improved banking service to customers. First, a BANKNET, a leaded line terrestrial network connecting 7 major cities in our country (Mumbai, Delhi, Chennai, Kolkata, Hyderabad, Bangalore, and Nagpur) was started.

RBI Net-a communication software uses BANKNET infrastructure for providing facilities of messages and file transfer between branches of banks and among banks.

The Indian Financial Networking (INFINET), a wide area satellite based networking using VSAT(Very Small Apparture Terminal) is inaugurated in June 1999. All branches, anywhere in the country, can be listed to each other, on this network. It will be operated round the clock on all days with its central Hub at the Institute for Development and Research in Banking Technology at Hyderabad. The INFINET is jointly set by the RBI and Hyderabad Institute.

The INFINET would cover in a phased manner 100 commercially important centres. It serves as the communication backbone of the Proposed Integrated Payment and Settlement System (IPSS).

4.11 INTERNET BANKING

Internet banking is the latest wave in information technology. It is anotehr electronic delivery channel. In simple terms internet banking means any user with a personal computer and a browser can get connected to his bank's Website to perform any of the virtual bankng functions. There is no human operator present in a remote location to respond to his needs such as in telephone banking, in a call centre. The bank has a centralised database that is web-enabled. All the services that the bank has permitted on the internet are displayed in menu. Any service can be selected and further interaction is dictated by the nature of service.

The traditional branch model of bank is now giving place to an alternative delivery channels with ATM network. Once the branch offices of bank are interconnected through terrestrial or Satellite links, there would no physical identity for any branch per se. It would a borderless entity permitting anytime, anywhere and anyhow banking.

The basic goal of banks is to create connectivity between each and every branch of the bank. The network which connects the various locations and gives connectivity to the central office within the organisation is called intranet. These networks are limited to organisations for which they are set up. These intranets can be connected to other intranets forming internet.

Intranet based online based online banking service is to aid dissmination and sharing of information in a closed group aiding better and faster flow. Intranet eliminates duplication of databases and inconsistencies thereof. There is centralised data which the users can download and find out what they want. SWIFT is a live example of intranet application. The contribution of Indian banks to SWIFT is negligible.

With electronic banking, clients are able to dial into banks and get a host of requests serviced through their desktop computers. For the client, it means direct and immediate access to his account in the bank, without having to physically visit the brach. They can transmit messages, all from thier homes or offices. For banks, the administration cost are lesser.

The quality, range and price of these electronic services decides a bank's competitive position in industry. Technology banking helps banks in four major ways: (i) to handle a greatly expanded customer base, (ii) to reduce the real cost of handling payments, (iii) to liberate banks from he traditional constraints on time and place and (iv) to introduce new products and services.

Virtual Banking

The term virtual banking is associated with electronic delivey of services. Basically, it means that customer is not interacting with bank staff across the counter. More and more customers are now using electronic delivery channels associated with virtual banking. They use new instruments such as credit cards, telebanking, ATMs, retail Electronic Funds Transfer (EFT) and Electronic Clearing Services (ECS).

The different types of services under virtual banking are :

1. ATMs - ATM networks - Shared ATM Networks.
2. Electronic Funds Transfer at Point of Sales (EFTPoS).
3. Remote Banking or Home Banking.

4. Smart Cards or Chip Cards.

5. Stored Value Card (SVC)

6. Super-Smart Card.

7. Internet Banking.

4.12 OFF-SHORE BANKING

Offshore banking is financial intermediation peformed for nonresident borrowers and depositors. It is a special category of entrepot financial services but its function is narrower. The main attraction for an offshore banking centre is simply the absence expensive regulaions by the host country, including taxation and portfolio decisions of the banking industry. Domestic residents may occasionally participate in an offshore market centre. But the domestic financial market is insulated from offshare banking activity by an arry of capital and exchange controls. The offshore banking facilities are thus confined to non-resident lenders and borrowers.

Many offshore banking centres have grown up in recent years, if we consider the major requirement for such centre are low taxes and minimum government controls. Four conditions are necessary for the development of an international entrepot centre.

1. Economic and Political stability, 2. An efficient and exprienced financial community, 3.Good communication and supportive sources and 4. An official regulatory climate favourable to the financial industry.

The important offshore Banking Centres are London, Luxembourg and continental European Centres, Singapore, Hongkong and Caribbean Financial Centres which are described as tax heavens.

In general, we can classify offshore financial centre into 4 different types according to sources and uses a funds for the market served by them.

Type of Offshore Financial Centres

Type	*Source of Funds*	*Use of Funds*	*Example*
Primary Centres	Worldwide	Worldwide	London New York
Booking Centres	Outside	Outside	Nassav (U) Cayman
Funding Centres	Outside	Inside	Singapore Island
Collection Centres	Inside	Outside	Baharin

The primary centre serves worldwide clinets. It provides complete arry of offshore financial services such a straditng in Euro Currencies and foreign exchange, international financial marketing, Euro credit management and Syndicarion and Euibond Underwriting.

The ICICI Bank has received approval to set up an offshore branch at Singapore in April, 2003. The Union Bank of India opened first offshore banking Unit SEEPZ-II in Mumbai which started functioning from July 31, 2003.

Following announcement in the EXIM Policy 2002-03, the RBI issued guidelines in November 2003 allowing banks operating in India to set up offshore banking units in special Economic Zones. These would virtually be foreign branches of Indian banks located in India. All banks in India, authorised to deal in foreign exchange are eligible to set up Offshore Banking Units, preference being given to banks having overseas branches.

4.13 TERMINOLOGY

SLR	-	Statutory Liquidity Ratio
CRR	-	Cash Reserve Ratio
IRDP	-	Integrated Rural Development Programme
BIFR	-	Board for Industrial and Finance Reconstruction
AIM's	-	Automatic Teller Machines
Credit Card-		It is post paid card holder can spend whereever, whenever with in the limits fixed.
PIN	-	Personal Identification Number
Debit Card- account		It is prepaid card with some stored value. If used by the holder, bank debits his
		immediately
PSB's	-	Public Sector Banks
FDI	-	Foreign Direct Investment
WTO	-	World Trade Organisation

4.14 SELF ASSESSMENT QEUSTIONS

Five Marks Questions

1. Credit card, Debit Card
2. Foreign Direct Investment
3. SLR and CRR
4. Directed Investment
5. Directed Credit Programme
6. ATM's
7. Mergers

Ten Marks Questions

1. Explain the need of appointing Narasimham Committee.
2. Explain reforms of banking sector.

Twenty Marks Questions

1. Explain the suggestions and implementations of Narasimham Committee regarding banking sector reforms and also?
2. What is Electronic Banking? Bringout its importance in present days.
3. Explain the innovations in Banking in India.

4.15 REFERENCE BOOKS

Indian Economy	-	Ruddar Datt & KPM Sundaram
Banking and Financial Systems	-	A.V.Ranganadha Chary & R.R.Paul
Banking and Financial Services	-	S.N.Maheswari & R.R.Paul.
Banking and Financial Systems	-	Mithani & E.Gordon.

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Lesson – 5

INDIGENOUS BANKERS

5.0 OBJECTIVES

→ Importance, role of indigenous bankers in financial market.

→ Functions and defects of indigenous banker

→ Role of Reserve Bank

→ Suggestions of Banking Commission.

→ Future of Indigenous bankers.

Structure

5.1 Introduction
5.2 Importance of Indigenous Bankers
5.3 Functions of Indigenous Bankers
5.4 Defects of Indigenous Bankers
5.5 Suggestions for Reforms
5.6 Indigenous Bankers and Reserve Bank
5.7 Indigenous Bankers and the Banking Commission.
5.8 Future of Indigenous Bankers
5.9 Terminology
5.10 Self Assessment Questions
5.11 Reference Books

5.1 INTRODUCTION

Indigenous banker constitute ancient banking system in India. They have been carrying on their age-old banking operations in different parts of the country under different names. Indigenous banking is mostly confined to certain castes like Khatris, Jains, Marwaris, Chettis etc., which are known as baking castes in India. In Madras, these bankers are called chettiyars, in Northern India Sahukars, Mahajans and Khatries and in Bombay they are called as shroffs and Marwaris and in Bengal they are called as Seths and Banias.

According to Indian central Banking Enquiry Committee, an indigenous banker is defined as, “any individual or private firm receiving deposits and dealing in hundies or lending money”. The sub committee on the Agricultural Finance in its report(1945), observes that the distinguishing feature of an indigenous banker lies not in accepting deposits but in discounting hundies.

5.2 IMPORTANCE OF INDIGENOUS BANKERS

The indigenous bankers occupy an important place in the Indian money market and play an important role in financing the internal trade. They are specially popular in the areas where joint stock banks do not properly serve. The growth of joint stock banking in the country, the activities of the indigenous bankers have declined considerably, still these bankers have control over a good deal of financial business.

Indigenous bankers are popular due to the following reasons.

1. They provide prompt and flexible credit.
2. They give loans to the small productive units not fully catered by the commercial banks.
3. They have cordial relationship with the customers.
4. They keep close contact with their customer and remain fully acquainted with their problems and financial requirements.
5. They are not merely bankers to their customers, but also their friends and advisers.

Because of the dichotomy of structure of the money market in India, indigenous bankers occupy a unique position in the financial system of the country. The scope for the growth of indigenous banking is widening due to rural development and accelerated overall economic growth in the country.

5.3 FUNCTIONS OF INDIGENOUS BANKERS

Indigenous bankers render the following services :

1. Accepting Deposits : They accept the deposits from the public. These deposits are of two types.(a) the deposits which are repayable on demand. (b) The deposits which are repayable after a fixed period. Indigenous bankers pay higher rate of interest that paid by commercial banks.
2. Advancing Loans : Indigenous bankers advance loans to their customers against all types of securities such as land, crops, gold and silver etc. They also give credit against personal security. They provide loans to small industrialists who cannot fulfil the necessary loan condition of commercial banks.
3. Business in Hundies: The indigenous bankers deal in hundies. They write hundies and buy and sell hundies. They also discount the hundies, and thereby, they meet the financial needs of internal traders. They also transfer funds from one place to another through discounting of hundies.
4. Non-Baking Functions : Most of the indigenous bankers also carry on their non-banking business along with the banking activities such as (a) they have their own retail trading (b) sometimes they act as an agent to large commercial firms and they earn income in the form of commission (c) They also participate in speculative activities.

5.4 DEFECTS OF INDIGENOUS BANKERS

The functioning of indigenous bankers suffer from the following :

(1) Mixing Banking and non-Banking Business : Indigenous bankers combine non-banking activities along with the banking business and commission agency. This is against the principle of sound banking.

(2) Unorganised Banking System : The indigenous banking system is highly unorganised and

segmented. Different indigenous bankers operate separately and independent. They have no co-ordination with each other have no link with other banking sector. Transfer of funds is not possible in such a system.

(3) Meagre Deposits Business : The main banking business of the indigenous bankers is to lend and deal in hundies. Their deposit business is very small. They do not mobilise saving of the general public.

(4) Insufficient Capital : The indigenous bankers largely depend upon their own capital and that of their family members or relatives. Therefore, the financial resources of these bankers are insufficient, to meet the demand of the borrowers.

(5) Defective lending : The indigenous bankers generally do not follow the sound banking principles while granting loans. They provide loans against insufficient securities or even against personal securities. They also extend the credit against immovable properties. They do not distinguish between short-term and long-term loans.

(6) Unproductive Loans : The indigenous bankers do not pay attention to the purpose for which the loan is used. They generally give money for unproductive and speculative activities, for paying interest or for paying off old debts.

(7) Higher Interest Rates : The indigenous bankers charge much higher interest rates from their borrowers. High rates of interest adversely affect the inducement to produce. Sir Daniel Hamilton says "The secret of successful industry is to buy your finance cheap and sell your produce dear. Indian buys finance dear ad sells his produce cheap. His creditor generally fixes the price for both".

(8) Exploitation of Customers : The indigenous bankers indulge in all types of malpractices and exploit their customers in many ways. (a) They make unauthorised deductions from the loans (b) They overstate the amount of loans in the document (c) They do not give receipt against the payment received.

(9) Secrecy of Accounts : The indigenous bankers keep secrecy about their accounts and activities. They need not get their accounts audited and publish annual balance sheet. This causes the suspicion in the minds of the people.

(10) Discourage the Bill Market : The indigenous banker also stand in the way of developing a proper bill market in the country. They very often give cash loans, and hundies pay a small role.

(11) No control of Reserve Bank : The indigenous banking business is unregulated. The Reserve Bank of India has no control over these bankers and can not regulate their activities. Hence, the indigenous bankers are a great hurdle in the way of creating an organised money market in the country.

5.5 SUGGESTIONS FOR REFORMS

To improve the functioning of indigenous banking in India, it is generally suggested that these bankers should be reformed and integrated with the organised banking system of the country.

Following are the suggestions have been made to reform the indigenous banking system.

(1) The indigenous bankers should be directly linked with the Reserve Bank. Such indigenous bankers are engaged in banking are prepared to shed their business other than banking should be eligible to be placed on the approval list of the Reserve Bank in the same manner as joint stock banks".

(2) Licensing should be introduced for indigenous banking.

(3) They should separate their non-banking business from banking business. Their activities should be linked with general banking.

(4) They should themselves reform their operational methods in consonance with modern banking.

(5) They should maintain their accounts properly and get them audited regularly.

(6) The wasteful competition should be ended between indigenous bankers and commercial banks.

(7) The commercial banks should be encouraged to cooperate with and provide help to the indigenous bankers.

(8) The indigenous bankers should stop various malpractices in their business.

(9) The Reserve Bank should supervise and inspect the conduct of indigenous bankers.

5.6 INDIGENOUS BANKERS AND THE RESERVE BANK

Since its inception in 1935, the Reserve Bank of India has been making efforts (a) to bring the indigenous bankers under its control (b) to integrate them with the modern banking system. (c) to provide various central banking facilities to them.

In 1937, the Reserve Bank of India prepared a scheme for direct linking with indigenous bankers under certain conditions. The main conditions are :

(1) They should have a minimum working capital of Rs.1 lakh which should be increased t Rs.6 lakh within five years.

(2) They should restrict themselves only to banking activities and should stop non-banking business

(3) They should maintain proper accounts, get them audited regularly by authorised auditors and allow their records inspected by the Reserve Bank.

(4) They should submit to the Reserve Bank periodic statements of the type required from the scheduled banks.

(5) The Reserve should have the right to regulate the banking business of these bankers.

But this scheme was not implemented because the indigenous bankers did not agree the various conditions included in the scheme. Besides, they did not consider the previleges offered by R.B.I. were adequate enough to compensate for the loss of their non-banking business.

In 1954, the Shroff Committee recommended that RBI should take necessary steps to encourage the rediscounting of hundies by RBI through the Scheduled banks. Similar proposals for the linking of the indigenous bankers with RBI and the organised money market were put forward among other, by the Bombay Shroffs Association and the Banking Commission (1972).

5.7 INDIGENOUS BANKERS AND THE BANKING COMMISSION

The Banking Commission (1972) has recognised the important role played by indigenous bankers particularly in the areas of small and medium categories of traders and businessmen, who are productive but not covered by the Commercial banks. They banking commission felt that for the proper functioning of banking system, the operations of the indigenous bankers should be regulated and institutionalised. The best way is to have indirect control over the indigenous bankers through Commercial banks. The Reserve Bank should lay down norms and guidelines for the Commercial banks to deal with indigenous bankers. The Commercial banks should provide the rediscounting facilities to the indigenous bankers on the fulfilment of the following conditions.

(1) They have to keep off the trading activities and confine themselves strictly to the baking business.

(2) They should have their own capital of not less than 1 lakh in the banking business.

(3) They are required to maintain regular books of accounts and have them duly audited.

(4) They are required to submit annual reports of their business to the Reserve Bank.

(5) They should not borrow from more than one bank.

(6) They should become members of an association.

(7) The banks should also satisfy themselves about the proper use of the credit sanctioned by them to the indigenous bankers and the interest rates charged by the indigenous bankers.

5.8 FUTURE OF INDIGENOUS BANKERS

With the extensive branch banking adopted by the commercial banks in the country, it was thought that the role of indigenous bankers would decline considerably. But the indigenous bankers have continued to play a prominent role in both towns and villages because of the risk they are prepared to face. The commercial banks are extremely rigid in lending to small borrowers. These small borrowers are not in position to show securities to get the credit for banks. Indigenous bankers make credit available to those sectors i.e., small scale business units and retail trade which are productive. Their methods of operation are also speedy and flexible. In cities, large and small towns, the indigenous bankers continue to find profitable scope for their business.

In the opinion of banking commission, the indigenous bankers would have to grow in size, become more professional in operation and diversify their business. They should link themselves with the organised financial system by taking on some of the activities of ancillary non-banking financial intermediaries. It is suggested that the prominent indigenous bankers would convert themselves into non-banking financial companies Now-a-days, in practice we are observing this situation.

5.9 TERMINOLOGY

Indigenous Bankers	:	Bankers of ancient period.
Banking Commission	:	Commission setup to improvise and regularise the working of indigenous bankers in India.
Hundies	:	Trade bills in modern periods

5.10 SELF ASSESSMENT QUESTIONS

5 Marks Questions

1. Importance of Indigenous Bankers.

2. Future of Indigenous Bankers.

10 Marks Questions

1. Suggestions of Banking Commission.

2. Indigenous Bankers and RBI.

20 Marks Questions.

1.Explain the importance of indigenous bankers in Indian Money Market? Explain their functions.

2.What are the defects of indigenous bankers ? What are the recommendations of Bank Commission of 1972.

5.11 REFERENCE BOOKS

Banking and Financial Services	S.N.Maheswari & R.R.Paul
Banking and Financial Systems	A.V.Ranganadha Chary & R.R.Paul
Indian Economy	Ruddar Datt & K.P.M.Sundaram

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Lesson 6

RESERVE BANK OF INDIA

6.0 OBJECTIVES

After going through this lesson student can know about

→ Objectives and Functions of RBI.

→ Monetary policy of RBI.

→ Credit control measures followed by RBI.

→ Recommendations of Chakravarthi Committee.

→ Achievements and failures of RBI.

Structure

6.1 Introduction
6.2 Management and Organisation
6.3 Objectives of RBI
6.4 Functions of RBI
6.4.1 Note Issue
6.4.2 Banker to the Government
6.4.3 Bankers Bank
6.4.4 Custodian of Exchange Reserve
6.4.5 Controller of Credit
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6.4.7 Development and Promotional Functions
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6.5.1 Introduction
6.5.2 Policy of Credit Expansion
6.6 Policy of Credit Control
6.6.1 Bank Rate
6.6.2 Cash Reserve Requirements
6.6.3 Statutory Liquidity Ratio
6.6.4 Open Market Operations
6.6.5 Selective and Direct Credit Controls
6.6.6 Credit Authorisation Scheme
6.6.7 Credit Monitoring Arrangement
6.6.8 Moral Suasion
6.7 Working of Indian Monetary System
6.8 Chakravarty committee Report
6.9 Achievements and Failures of Reserve Bank
6.10 Summary
6.11 Terminology
6.12 Self Assessment Questions
6.13 References

6.1 INTRODUCTION

The Reserve Bank of India is India's Central Bank. It is the apex monetary institutions which supervises, regulates, controls and develops the monetary and financial system of the country. The Reserve Bank was established on April, 1935 under the Reserve Bank of India Act, 1934. It was share holder bank with a fully paid up capital of Rs. 5 crore. But in was nationalised on January 1, 1949.

6.2 MANAGEMENT AND ORGANISATION

The management of RBI is under the control of Central Board of directors which consists of 20 members.

(a) The executive head of the bank is called governor who is assisted by four deputy governors. They are appointed by the Government of India for period of five years.

(b) There are four local boards at Delhi, Calcutta, Madras and Bombay 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 from each board to the Central Board.

(c) There are ten directors from various fields and one government official from the ministry of finance.

The Governor of the Reserve Bank can call a meeting of Central Board whenever he feels it necessary. The governor and deputy governor are full-time and prescribed salaried officials. Other directors are the part-time officials and are given allowance and fare to attend the meetings.

Organisation :

Organisationally, the Reserve Bank works through various departments. They are-

(1) Issue Department : Its functions is to issue and distribute the paper currency

(2) Banking Department : This department (a) Deals with government transactions, manages public debt and arranges for the transfer of government funds, (b) Maintain the cash reserves of the scheduled banks, (c) Works as a clearing house.

(3) Department of Banking Development :It expands the banking facilities in unbanked and rural areas.

(4) Department of Banking Operations : It grants licenses for opening new banks or new branches of existing banks. The function of this department is to supervise, regulate and control the working of banking institutions in the country.

(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 : It supervises the activities of non-banking companies and financial institutions in the country.

(8) Exchange Control Department : It conducts the 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 Reserve and Statistics :The function of this department is (a) to conduct research on various aspects i.e., on money, credit, finance, production etc.

(b) collect statistics relating to various aspects of the economy

(c) Publish these statistics

(11) Department of Planning and Reorganisation : It deals with the formulation of new plans or reorganisation of existing policies for making them more effective

(12) Economic Department :It is concerned with framing proper 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 Service Board : It deals with the selection of new employees, for different posts in the Reserve Bank.

6.3 OBJECTIVES OF RBI

The main objectives of RBI are

(a) Regulating the issue of currency in India.

(b) Keeping the foreign exchange reserves of the country.

(c) Establishing the monetary stability in the country.

(d) Developing the financial structure of the country on sound lines consistent with the national socio-economic objectives and polities.

6.4 Functions of the RBI

The RBI performs various traditional Central Banking functions, and also undertakes the development and promotional functions. Following are the main functions performed by RBI.

6.4.1 Note Issue

The RBI has a separate department which is engaged in issuing notes. It has the monopoly of note issue in the country. It has the right to issue currency notes of all denominations except one rupee notes. But it acts as the only source of legal tender because even one rupee notes are circulated through it. The RBI maintains minimum reserve system of note issue. Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 crore, of which at least Rs. 115 crore should be in gold.

6.4.2 Banker to the Government

The RBI renders useful service to the government in the capacity of its banker, agent, and advisor. The RBI has the obligation to transact the banking business of Central and State Governments.

(1) It maintains and operates government deposits.

(2) It collects and makes payments on behalf of the government.

(3) It helps the government to manage the public debt by granting new loans.

(4) It sells for the central government treasury bills of 91 days duration.

(5) It makes 'ways and means' advances to the central and state government for periods not exceeding three months.

(6) It provides development finance to the government for implementing five year plans.

(7) It undertakes foreign exchange transactions on behalf of the central government.

(8) It acts an agent while dealing with International Monetary Fund, the World Bank, and other International Financial Institutions.

(9) It advises the government on all financial matters such as loan operations, investments, agricultural and industrial finance, banking, planning, economic, development etc.

6.4.3 Banker's Bank

The Banking Regulation Act of 1949 and the various amendments made there in define the RBI's regulatory functions relating to banks. These functions are quite extensive and cover such areas as the licensing of banks, branch expansion, liquidity of the assets of commercial banks, their management and methods of working, amalgamation, reconstruction and liquidation.

According to the Banking Regulation Act,1949, all banking companies included in the second schedule of the RBI are called Scheduled Banks. For including in second schedule, a bank must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interest of the depositors. All Scheduled Banks are under a statutory obligation to maintain a certain minimum of cash reserve with the RBI against their demand and time liabilities.

An amendment of 1962 to the Banking Regulation Act has empowered the RBI to determine the cash reserve ratio between 3 per cent to 15 percent of aggregate demand and time liabilities. The RBI can also direct scheduled banks to maintain 100 percent cash reserve against all deposits received after a specified date. And the scheduled banks are required to submit weekly statements of their transactions to the RBI.

The RBI also provides financial assistance to scheduled commercial banks and state co-operative banks by discounting eligible bills and loans and advances against approved securities. As it is the responsibility of the RBI to see that the banking system in the country grows on sound lines, it observes the financial position of borrowing bank. Its lending policy and the securities offered while making advances to it. The RBI has the power to deny rediscounting facility of any bank without assigning any reason for it.

For exercising its control over the commercial banks, it conducts their inspection by its own staff and also calls for returns and other necessary information. If it feels unsatisfactory, it can suggest remedial measure.

6.4.4 Custodian of Exchange Reserve

The Reserve bank is the custodian of India's foreign exchange reserves. It maintains and stabilises the external value of the Rupee, administers the exchange controls and restrictions imposed by the government and manages the foreign exchange reserves.

During World War II, for tackling balance of payments problems, various monetary and fiscal tools were inadequate. In these conditions, no remedy was available, India implemented direct methods of exchange control, which later became a permanent instrument of economic management.

Initially the stability of exchange rate was maintained through selling and purchasing sterling at fixed rates. Prior to 1947, exchange controls were exercised under the Defence of India Act. In 1947 the Foreign Exchange Regulation Act (FERA) was passed and through it the RBI exercises its power of foreign exchange management. Later FERA was substituted by Foreign Exchange Regulation Act, 1973. FERA provided that no authorised person would buy or sell foreign exchange. Now FERA has been replaced by Foreign Exchange Management Act (FEMA).

6.4.5 Controller of Credit

The Reserve Bank undertakes the responsibility of controlling credit in order to secure internal stability and promote economic growth. So that the Reserve Bank attempts to achieve price stability in the country and avoids inflationary and deflationary tendencies in the country. The Reserve Bank regulates money supply in accordance with the changing requirements of the economy. The Reserve Bank makes extensive use of various qualitative and qualitative techniques to effective control and regulate credit in the country.

6.4.6 Agricultural Finance

Although the RBI has been established on the model of the Bank of England, it has a unique feature in its character. The agricultural credit department of RBI clearly distinguished it from the Central Bank of developed countries. Making his observations on RBI's role in agricultural finance B. Rama Rao, a former governor of the RBI has stated that "RBI could not have justified its existence in India if it confined its activities to the industrial sector and completely ignored agricultural sector, on which industrial development to a large extent depended". Therefore, this function has a particular significance in agricultural country like India. For this purpose RBI set up a special agricultural credit department. But its major function was taken over by National Bank for Agricultural and Rural Development which was established July 12, 1982.

6.4.7 Development and Promotional Functions

Besides the traditional central banking functions, the Reserve Bank performs a variety of promotional and development functions.

(a) It helps the commercial banks to expand their branches in semi-urban and rural areas.

(b) It reduces the dependence of people on unorganised sector of indigenous bankers and money lenders.

(c) It develops the banking habit of people.

(d) By establishing the Deposit Insurance Corporation, RBI helps to develop the banking system of the country, and attains confidence of the depositors and avoids bank failures.

(e) Through Unit Trust of India, it helps to mobilise saving in the country.

(f) It has been making its efforts to promote institutional agricultural credit through co-operative credit institutions.

(g) It helps to promote industrial credit through specialised institutions for industrial finance.

(h) It takes necessary measures for the development of bill market in the country.

6.5 Monetary Policy of the Reserve Bank of India

6.5.1 Introduction

With the introduction of the five-year plans, the need for appropriate adjustment in monetary and fiscal policies to attain the planned development in the economy. Since the first plan period, the RBI adopts a policy of “Adequate financing of economic growth and at the same time ensuring reasonable price stability”. Following are the aims of economic policy of the government.

(a) Speed up economic development in the country to raise national income and standard of living.

(b) To control and reduce in flationary pressure in the economy.

Monetary and fiscal policies are closely related, and should be persuaded in co-ordination with each other. Generally, Fiscal policy brings about changes in money supply through the budget deficit. An excessive budget deficit shifts the burden of control of inflation to monetary policy. This requires a restrictive credit policy. On the other hand, a fiscal policy keeps the budget deficit at a very low level, and free from the burden of adopting an anti-inflationary monetary policy. The monetary policy can play a positive role in promoting economic growth by extending credit facilities to development programmes. The monetary policy of Reserve Bank termed as “Controlled Expansion”. It aims at adequately financing for economic growth and ensuring reasonable price stability in the country.

6.5.2 Policy of Credit Expansion

This expansion has been achieved by adopting the following measures.

1.Revision of Open-Market Operations :

Open market operations of 1956, RBI started giving discriminatory support to the sale and purchase of government securities. Later, the bank’s sales of government securities to the public exceeded its purchases. The excess sales method was discontinued with a purpose of expanding currency an credit in the economy.

2. Liberalisating the Bill Market Scheme :

Since 1957, the Reserve Bank extended the bill market scheme to include export bill in order to help the commercial banks to provide credit to exporters liberally.

3.Facilities to Priority Sectors :

The Reserve Bank continues to provide credit facilities to priority sector such as small scale industries and co-operatives, even though the general policy of bank is to control credit expansion.

4. Refinance and Rediscounting Facilities :

In recent years, the Reserve Bank has been following a policy of providing selective refinance and rediscounting facilities.

5. Credit Facilities through Financial Institutions :

The Reserve Bank provides medium-term and long-term credit facilities for development through various financial institutions like-

- Industrial Development Bank of India (IDBI)
- Industrial Finance Corporation of India (IFCI)
- Industrial Reconstruction Corporation of India (IRCI)
- Industrial Credit and Investment Corporation of India (ICICI)
- State Finance Corporations (SFCs)
- Agricultural Refinance and Development Corporation (ARDC) and
- National Bank for Agricultural and Rural Development (NABARD)

6. Deficit Financing :

Continuous increase in money supply has been caused by adopting the method of deficit financing to finance the budgetary deficit of the government. This has been made possible through changes in the reserve requirements of the Reserve Bank.

7. Anti - Inflationary Fiscal Policy :

A Fiscal policy that keeps the budget deficit down would give greater autonomy policy. An anti-inflationary fiscal policy will liberate the Reserve Bank for its anti-inflationary responsibilities and will enable to extend sufficient credit facilities for the development of industry and trade.

8. Allocation of Credit :

The pattern of allocation of credit is in accordance with the plan priorities. A certain minimum of credit at concessional rates of interest is ensured for priority sectors through selective credit control, and the differential rate of interest scheme.

6.6 Policy of Credit Control

Along with the development and expansionary requirements of the economy, the Reserve Bank has also been assigned the task of controlling the inflationary pressure in the economy. The Reserve Bank has adopted a number of credit control measures to check the inflationary tendencies in the country.

6.6.1 Bank Rate

The bank rate is the rate at which the Reserve Bank advances to the member banks against approved securities or rediscounts the eligible bills of exchange and other papers. Changes in bank rate influences the entire structure of interest rates. A rise in bank rate leads to a rise in interest rates of other markets which implies a dear money policy increasing the cost of borrowing. Similarly, a fall in the bank rate results in a fall in other market rates, which implies a cheap money policy reducing the cost of borrowing.

RBI states with a cheap money policy and fixed a low bank rate (3%) and did not change it till November 1953 when it raised the bank rate to 3.5 percent. The bank gradually rises it to 10% in July 1981, and later 11% in July 1991 and 12% in October 1991. The role of bank rate as an instrument of monetary policy has been very limited in India because of these basic factors :

(1) The structure of interest rates is administered by RBI - They are not automatically linked to the bank rate.

(2) Commercial Banks enjoy specific refinance facilities and not necessarily rediscount their eligible securities with RBI at bank rate and

(3) The bill market is under developed and the different sub-markets of the money market are not influenced by the bank rate.

Since the later part of 1995, India passed through a severe liquidity crunch and as a result the prime lending rates were ruling high. Industrial production was affected adversely. In April 1997 the RBI reduced the bank rate from 12 percent to 11. This reduction of bank rate was to help in the reduction of other interest rates which stimulates the borrowings from other banks.

6.6.2 Cash Reserve Requirements

Another weapon available to RBI for credit control is the use of variable cash reserve requirements. Under RBI Act, 1934 every commercial bank has to keep certain minimum cash reserves with RBI. Initially, it was 5 percent against demand deposits and 2 percent against time deposits. Since 1962, RBI was empowered to vary the cash reserve requirement between 3 percent and 15 percent of the total demand and time deposits. RBI raised C.R.R from 3 to 15% in June 1973 and 7 percent in September 1973. Since then RBI has raised or reduced CRR a number of times and finally raised to 15 percent of net demand time liabilities to influence the volume of cash with commercial banks which influence their volume of credit.

RBI has reduced CRR to 8 percent in 1997 and finally to 5 percent in June 2002.

6.6.3 Statutory Liquidity Ratio (SLR)

Under sec 24 of Banking Regulation Act, 1949, all commercial banks have to maintain liquid assets in the form of cash, gold and unencumbered approved securities equal to not less than 25 percent of their total demand and time deposit liabilities. This is known as the statutory liquid requirement, in addition to statutory cash reserve requirements.

RBI was given the power to change the liquidity ratio from 25 percent gradually and finally to 38.5 percent. RBI has increased SLR for two reasons :

(1) Higher liquidity ratio forces commercial banks to maintain in larger portion of their resources in liquid form and thus reduces their capacity to grant loans and advances to business and industry and they are anti-inflationary.

(2) A higher SLR was used to divert bank funds to finance government expenditure.

After accepting Narasimham Committee (1991) recommendation, RBI reduced the SLR by 25 percent in October 1997. There is now a demand to abolish SLR together.

6.6.4 Open Market - Operations

Since 1991, the enormous inflow of foreign funds into India created the problem of excess liquidity with the banking sector. RBI undertook large scale open market operations. When RBI sells government securities in the market, it withdraws a part of the cash reserves of commercial banks which reduces the ability of banks to lend. At any given time, the capacity of banks to create credit depend up on their excess cash, i.e., the excess amount of cash reserves in excess of their statutory CRR. Once the surplus cash is eliminated and even part of the statutory CRR is reduced, the banks have to contract their credit supply. As a result, bank credit falls and money supply contracts.

Opposite is the case, when the RBI buys government securities from the market. The commercial banks will fund their surplus cash. They will create more credit and more bank deposits. The supply of money will expand. Hence, RBI will actively use open market operations as an instrument of monetary policy and not simply to support the market for government bonds.

6.6.5 Selective and Direct Credit Controls

Under the Banking Regulation Act 1949, section 21 empowers RBI to issue directives to the banking companies regarding their advances.

These directions may relate to :

(1) The purpose for which advances may or may not be made.

(2) The margin to be maintained in respect of secured advances.

(3) The maximum amount of advance to any borrower.

(4) The maximum amount up to which guarantees may be given by the banking company on behalf of any firm, company etc.

(5) The rate of interests and other terms and conditions for granting advances.

Many other direct controls have been imposed by RBI on the nationalised banks in the matter of their credit operations. Generally RBI uses three kinds of selective credit controls :

(1) Minimum margins for lending against specific securities.

(2) Ceiling on the amounts of credit for certain purposes and

(3) Discriminatory rate of interest charged on certain types of advances.

6.6.6 Credit Authorisation Scheme (CAS)

This scheme was introduced by RBI in November 1965. Under this scheme the commercial banks have to obtain RBI's authorisation before sanctioning any fresh credit of Rs. 1 crore or more to any single party. This was raised gradually to Rs. 6 crores in April 1986 in respect of borrowers in private as well as public sectors. The cut off point for all manufacturing units and exports was raised to Rs.7 crores. CAS was further liberliased in July 1987 to allow for greater access to credit to meet genuine demands in population sectors without prior sanction of RBI. With a view to deregulate and liberalise the financial system in the country, RBI took a series of steps after 1987. One of the major steps taken by RBI was to abolish Credit Authorisation scheme (CAS) in October 1988.

6.6.7 Credit Monitoring Arrangement (CMA)

To ensure that the basic financial discipline continued to be observed by banks, RBI would monitor and scrutinises all sanctions of bank loans exceeding

(1) Rs. 5 crores to any single party for working capital requirements and

(2) Rs. 2 crores in case of term loans.

This post sanction scheme has been designated as Credit Monitoring Arrangement (CMA).

6.6.8 Moral Suasion

The Reserve Bank has also been using moral suasion as a selective credit control measure. It has been sending periodic letters to the commercial banks to use restraint over their credit policies in general and in respect to certain commodities and unsecured loans in particular.

6.7 Working of the Indian Monetary System

The Central Banking Enquiry Committee reviewed the working of Indian monetary system in twenties and thirties of this century, and so many changes had taken place in the Indian economy. Since Independence, the Indian monetary system has helped in the mobilisation of resources in the implementation of the first five year plans and has also attempted to control the inflationary process, Inherent in rapid economic development. The Reserve Bank of India wanted a fresh look at the Indian monetary system and accordingly appointed a committee in December 1982 with professor Sukhamoy Chakravarty as Chairman to review the working of Indian monetary system. The Chakravarty committee was asked :

(a) To review critically the structure and operation of the monetary system in the context of the basic objectives of planned development.

(b) To evaluate the various instruments of monetary and credit policies.

(c) To recommend suitable measures for the formulation and operation of monetary and credit policies and for strengthening the instruments of monetary and credit policies. Chakravarty Committee submitted its report in May 1985.

6.8 Chakravarty Committee Report

Following are the main recommendations of the committee.

(1) Objectives of Price Stability :

The monetary authority should pursue the objective of price stability in the broadest sense. To achieve the objective of price stability, both supply management and demand management measures are to be pursued

(a) The government should aim at raising output levels and

(b) The reserve Bank should control the money supply.

(2) Monetary Targeting :

The committee observed that the major cause of substantial increase in the money supply since 1970 has been the rise in Reserve and credit to government, as reflected in the high degree of monetisation of debt. The reason for excessive monetisation of debt are

(a) Relatively low yield of government securities

(b) The low discount rate of the Reserve Bank on Treasury bills, the government should raise its financial resources either by mobilising the public saving or by increasing tax revenues or by borrowing from sources other than the Reserve Bank.

(3) Redefining budgetary Deficit :

The Committee suggested a change in the definition of budgetary deficit so as to make it an economically meaningful and unambiguous measure of the monetary impact of fiscal operations. The present definition of budgetary deficit includes only changes in the treasury bills out standing. The definition overstates extent of monetary impact of fiscal operations.

(4) Interest Rate Policy :

The Committee has made the following recommendations regarding the policy of rate of interest.

(a) Banks should have greater freedom in determining their lending rates. This prevents the excessive use of credit because of relatively low rates.

(b) Concessional rates as a distributive device should be used in very selective manner.

(c) The interest rates on bank deposits should be positive after adjusting for inflation. This encourages small savers.

(d) The interest rates should reflect the real cost of long term loans for industrial projects.

(5) Bank Credit Policy :

The Committee has made the following recommendations regarding the credit policies and procedures of the banks to ensure more efficient use of bank credit.

(a) Bank credit should be granted in the form of loans and bill finance, rather than predominating in the form of cash credit.

(b) There should be stricter discipline in the use of bank credit. Loan requests should be more carefully examined.

(6) Priority Sector Lending :

In order to improve the effectiveness of priority sector lending the committee has emphasised the need of organisational reorientation and effective communication and monitoring. Credit delivery system should be strengthened in the area of priority sector lending so that sufficient and timely credit is made available to this sector.

(7) Development of Money Market :

The Committee has asked the Reserve Bank to take measure system of the economy should be reconstructed in such a way that the Treasury Bill Market, the Call Money Market, the Commercial Bill Market are able to play an important role in the allocation of short-term resources with minimum transaction cost and minimum of delay.

(8) Role of Reserve Bank :

The Committee has made certain recommendations to improve the functioning the Reserve Bank of India.

(a) The Reserve Bank should not depend much on any single instrument of monetary policy.

(b) The Reserve Bank should adopt the regulatory measures early and slowly so that the effects of such measures are not too drastic and create hardships to the specific sectors.

(c) The creation of reserve money should be kept within limits.

(d) The development institutions should secure their working funds ordinarily from sources other than the Reserve Bank and Reserve Bank's support to these institutions should be only secondary.

The government has accepted most of the recommendations of the Chakravarty Committee.

(1) In the 1986-87 budget presented to parliament, the government accepted the modified definition of budget deficit as suggested by the committee.

(2) The Government has accepted the recommendation for setting up of the over-all monetary targets with feed back to enable changes in the target in the light of emerging trends in output and prices. RBI has been setting up operationally meaningful monetary targets and monitoring them regularly.

(3) The government has accepted the committee's recommendations to Develop Treasury Bills as a monetary instrument. Accordingly treasury bills of 182 days maturity and later 364 days maturity are being issued on a monthly auction basis. The rate of discount and the corresponding issue price of these bills are flexible and are determined through auctions.

(4) The government has accepted the committee's recommendations for an upward revision of yields on government securities coupled with shortening of maturities to attract funds from the capital market. The government has been increasing the yield on government securities according to market conditions.

6.9 Achievements and Failures of Reserve Bank

Since its inception in 1935, the Reserve Bank of India has functional with great success, not only as the apex financial institution in the country, but also as the promoter of economic development. The major contributions of the Reserve Bank to economic development are as follows :

1) Promotion of Commercial Banking :

The Banking Regulation Act, 1949 has given the Reserve Bank vast powers of supervision and control of Commercial Banks in the country. The Reserve Bank has been using these powers

(a) To strengthen the commercial banking structure through liquidation and amalgamation of banks.

(b) To extend the banking facilities in the semi-urban and rural areas.

(c) To promote the allocation of credit in favour of the priority sector such as agriculture, small scale industries, exports etc.

2) Development of Bill Market :

The Reserve Bank introduced the Bill Market scheme in 1952, with a view to extend loans to the commercial banks against demanded promissory notes. The scheme was not based on the genuine Trade Bills, but up on the conversion of loans and advances of the banks into Usance Bills. This scheme has helped a lot in developing the bill market in the country. Later, RBI introduced the new bill market scheme which covered the genuine trade bills representing sale or dispatch of goods.

3) Promotion of Rural Credit :

The Reserve Bank has taken the following efforts to promote rural credit.

(a) It has set up the agricultural credit department to expand and co-ordinate credit facilities to the rural areas.

(b) On the recommendation of rural credit survey committee, it has been attempting all necessary measures to strengthen the co-operative credit system with a view to meet the financial needs of the rural people.

(c) In1956, the bank set up two funds i.e., the National Agricultural Credit (long -term operations) Fund and National Agricultural Credit (stabilisation fund) for providing medium and long term loans to the state co-operative Banks.

(d) One of the main objectives of nationalisation of commercial banks was to expand bank credit facilities in rural areas.

(e) Regional rural banks have been established.

(f) The National Bank for Agriculture and Rural Development has been established in 1982 as the apex institution for agricultural finance.

4) Promotion of co-operative Credit :

Promotion of co-operative Credit movement is also the special function of Reserve Bank. In 1951, the bank appointed Rural Credit survey committee to meet the credit requirements of the rural people. On the recommendation of the committee, the RBI has taken a number of measures to strengthen the structure of co-operative credit institutions throughout the country to liberalise the co-operative credit and to increase the share of co-operative credit in rural areas. The RBI does not provide its financial assistance to agriculturists directly, but through co-operative institutions.

5) Promotion of Industrial Finance :

In 1957, Reserve Bank has set up a separate Industrial Finance Department which has rendered useful service in extending financial and organisational assistance to the institutions providing long-term industrial finance. The Reserve Bank established various financial institutions such as Industrial Development Bank of India, Industrial Finance Corporation of India, The State Finance Corporation, The State Industrial Development Corporations, The Industrial Credit and Investment Corporation of India etc. The Reserve Bank also encourages bank credit to small scale industries small scale industries have been recognised as a priority sector.

6) Promotion of Export Credit :

The Reserve Bank promotes export finance through various measure.

(1) It provides refinance facilities to banks to encourage export credit under various schemes such as Bill Market Scheme (1958), Export Bills Credit Scheme (1963), Pre-shipment Credit Scheme (1969), Duty Draw back Credit Scheme (1976).

(2) The RBI, has been granting concessional interest rates on various types of export credit granted by scheduled banks.

(3) Export has been recognised as a priority sector and receive preferential treatment from the banks with regard to the availability of credit.

(4) In 1982, the Government of India has set up the Export - Import Bank as the apex institution for financing foreign trade.

7) Credit to Weaker Sections :

The Reserve Bank has taken the following measures to encourage adequate and cheaper credit to the weaker sections of society.

(a) In 1971 the Credit Guarantee Corporation of India was set up which was later converted into Deposit Insurance Corporation in 1978.

(b) In 1972, the differential rate of interest scheme was introduced.

8) Regulation of Credit :

The Reserve Bank has been using various credit control weapons to regulate

(a) The cost of credit

(b) The amount of credit

(c) The purpose of credit

It has been using the quantitative measure to control credit. By regulating credit, the Reserve Bank has been able to certain extent

(a) To promote economic growth in the country

(b) To prevent financial resources from being used for speculative purposes

(c) To prevent financial resources available for productive purposes

(d) To make financial resources available for productive purpose and

(e) To encourage savings in the country.

Other achievements of the Reserve Bank are :

(1) It can remove the variations in the rate of interest in different seasons.

(2) It has been stabilisng the bank rate in the country.

(3) It has been managing the public debt in the country with great success. 'Way and Means' funds are also arranged for the government through the sale of treasury bills.

(4) It has been providing cheap remittance facilities to the government; the scheduled banks and co-operative banks for the transfer of funds from one place to another.

(5) It has also been able to maintain the stability of the exchange value of the rupee under heavy strains and pressure.

(6) It has also successfully represented the country in international monetary conferences.

(7) The research and statistical department of Reserve Bank has been conducting and encouraging research.

(8) It has been making clearing facilities in different centres of the country.

(9) It is also extending training facilities to the supervisory staff of the banks through its banker's training colleges.

Failures :

Major failures of the Reserve Bank are given below :

(1) A large part of Indian money market still remains outside the control of the Reserve Bank.

(2) The Reserve Bank has not succeeded in developing Indian Exchange Bank.

(3) The Reserve Bank failed to protect some of the member banks in times of crisis.

(4) The Reserve Bank has also not been able to successfully develop the bill market in the country.

(5) Inspite of several credit control measures taken by they Reserve Bank, it has not been able to control effective. The rapidly increasing credit and money supply in the country.

(6) The Reserve Bank could not exercise its effective control over the expansion of black money and other unproductive activities in the economy.

(7) Inspite of many attempts made by the Reserve Bank to improve and expand agricultural finance in the country, adequate and cheap credit is still not available to the Indian farmers.

Despite certain failures and short comings of the Reserve Bank, the overall performance of the bank is quite satisfactory. It has efficiently operated the credit and currency system and achieved fair degree of monetary stability.

6.10 SUMMARY

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 the country.

1. The main Objectives of RBI are a) regulating the issue of currency in India. B) Monetary stability, etc.

2. Functions of RBI - 1) Note issue, 2) Banker to the government, 3) Banker's Bank 4) Custodian of Exchange Reserve. 5) Controller of credit 6) Agricultural Finance, etc.

3. Monetary Policy of RBI - Aims of Policy - 1) Speed up economic development in the country 2) to control and reduce inflationary pressure in the economy.

4. Achievements of RBI - Promotion of Commercial banking, development of bill market, promotion of rural credit and co-operative credit, promotion of Industrial finance, promotion of export credit, credit to weaker sections and regulation of credit.

5. Failures - The major failures are 1) large money market remains outside the control of the RBI. 2) has not succeeded in developing Indian Exchange Bank. 3) failed to protect some of the member banks in times of crisis, etc. 4) Inspite of many attempts made by RBI to extend agricultural finance, adequate and cheap credit is still not available to the Indian Farmers.

6.11 TERMINOLOGY

1. Bank Rate : The bank rate is the rate at which the Reserve Bank advances to the member banks against approved securities or rediscount the eligible bills of exchange and other papers.

2. Cash Reserve Requirements - Under RBI Act, 1974 every Commercial Bank has to keep certain minimum cash reserves with RBI.

3. Statutory Liquidity Ratio - Under sec. 24 of Banking Regulation Act 1949, all commercial banks have to maintain liquid assests in the form of cash, gold and some securities equal to not less than 25 percent of their total demand and time deposit liabilities.

4. Open Market Operations - RBI Controls the problem of excess liquidity and the problem of lack of funds to create credit through open market operations.

6.12 SELF ASSESSMENT QUESTIONS

1. Explain the concept of Management and Organisation of RBI
2. Explain the functions of Reserve Bank of India.

6.13 REFERENCE BOOKS

Indian Economy	-	Ruddar Datt & KPM Sundaram
Banking and Financial Systems	-	A.V.Ranganadha Chary & R.R.Paul
Banking and Financial Services	-	S.N.Maheswari & R.R.Paul.
Banking and Financial Systems	-	Mithani & E.Gordon.

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LESSON - 7

CO-OPERATIVE BANKS

7.0 Objective :

This lesson explain the organisation structure, role and functions of each of the cooperative bank at different levels in the cooperative banking system in India. It explains the linkages between RBI, NABARD and Cooperative banks. It also explains the creation, activities, progress and performance, evaluation and problems of RRBS.

Structure

7.1 Introduction
7.2 Meaning and Definition of Cooperative Bank
7.3 History of Cooperative Banking
7.4 Structure of Cooperative Banking System in India
7.5 Primary Agricultural Credit Societies
7.6 Central Cooperative Banks
7.7 State Cooperative Banks
7.8 Importance of Cooperative Banks
7.9 Weaknesses of Cooperative Banking
7.10 Regional Rural Banks
i) Functions
ii) Organisation & Structure
iii) Differences between RRB's and Scheduled Commercial Banks
iv) Progress of RRB's
v) Defects of RRB's
7.11 NABARD
i) Objectives of NABARD
ii) Organisation & Structure
iii) Functions
iv) Working of NABARD
7.12 Summary
7.13 Self Assessment Questions
7.14 Reference Books

7.1 INTRODUCTION :

The co-operatives play an important role in the Indian financial system, especially at the rural level. An important segment of the organised sector of the Indian Banking System is the Co-operative Banks. The Government of India though it is necessary to establish rural banks as subsidiaries of the public sector banks to cater to the credit needs of rural people.

7.2 MEANING AND DEFINITION OF CO-OPERATIVE BANK :

Co-operation means voluntary association on the basis of equality and for some common purpose. The basic principle of Co-operation is "each for all and all for each". In the words of H.Calvert, " Cooperation then is a form of organisation where in persons voluntarily associate together as human beings on the basis of equality for the promotion of their economic interest.

The features of Co-operative Society are :

i) Its membership is voluntary

ii) Its Organisation is democratic

iii) Its functioning is based on decentralised decision making

iv) Its aim is economic, social and moral development of its members

v) It is non exploitive in character

vi) It combines the benefits of private ownership and public good.

Cooperative Bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks the cooperative banks are funded by collecting funds through shares and deposits etc. The Co-operative banks however differ from joint stock banks in the following manner.

1. Cooperative banks issue shares of unlimited liability, while the Joint stock banks issue shares of limited liability.

2. In a Co-operative one shareholder has one vote whatever the number of shares he may hold. In a joint stock bank the various right of a share holder is determined by the number of share he pos sesses.

3. Co-operative Banks are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities. Joint stock companies are primarily concerned with the credit require- ments of trade and industry.

4. Co-operative banking in India is federal in structure. It has three tier structure. Joint stock banks do not have such a federal structure.

5. Cooperative credit societies are located in the villages spread over the entire country. Joint stock banks and their branches mainly concentrate in the urban areas.

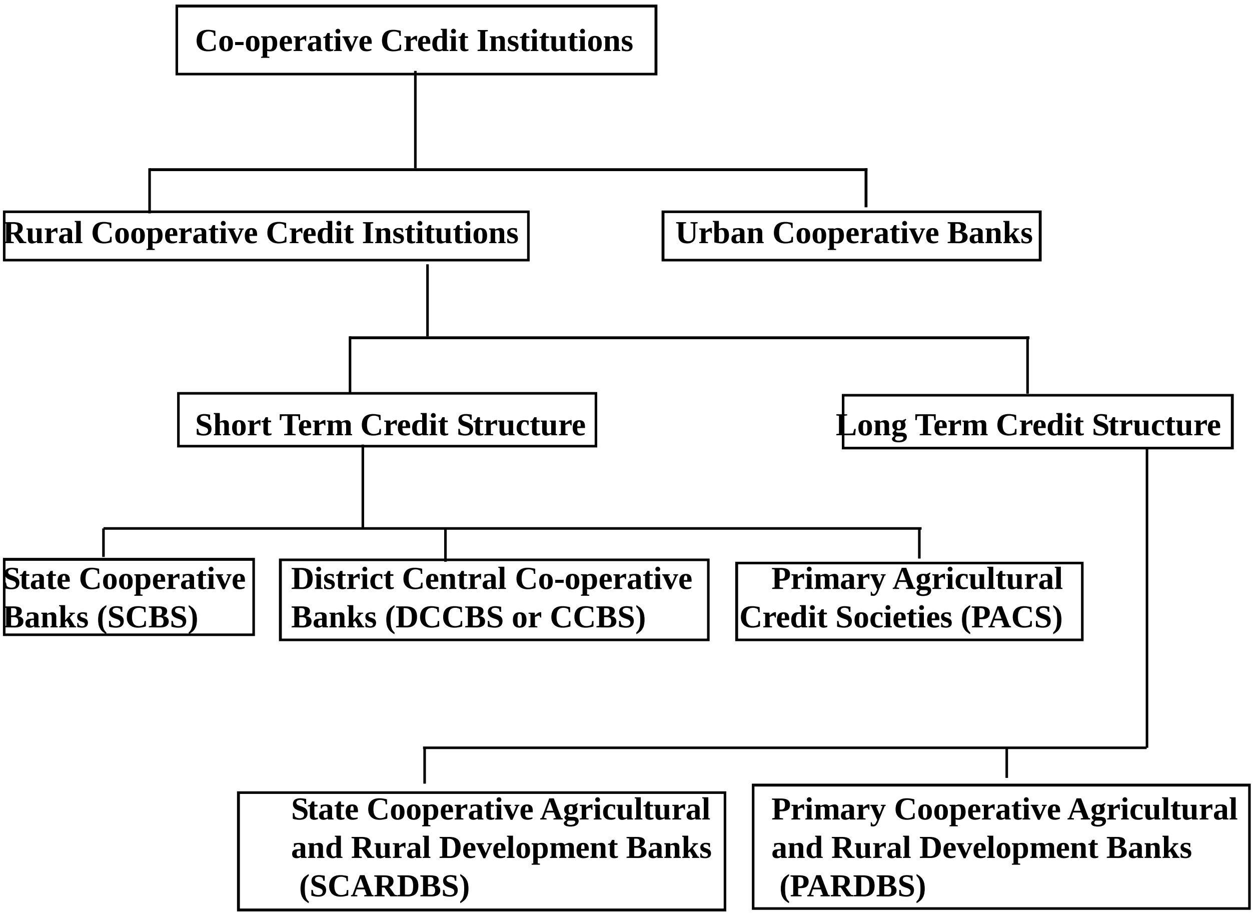
7.3 HISTORY OF CO-OPERATIVE BANKING IN INDIA :

In India Co-operative movement was started mainly for dealing with the problem of rural credit. The Indian co-operative banking started with the passing of cooperative societies Act in 1904. The objective of the Act was to establish cooperative credit societies " to encourage thrift, self help and co-operation among agriculturists artisans and persons of limited means". Many co-operative credit societies were set up under this Act.

7.4 THE STRUCTURE OF CO-OPERATIVE BANKING SYSTEM IN INDIA :

The Co-operative banking system in India has a three tiered federal structure.

Organisational Structure of the Co-operative Credit Institutions


Co-operative Credit Institutions
Rural Cooperative Credit Institutions
Urban Cooperative Banks
Short Term Credit Structure
Long Term Credit Structure
State Cooperative Banks (SCBS)
District Central Co-operative Banks (DCCBS or CCBS)
Primary Agricultural Credit Societies (PACS)
State Cooperative Agricultural and Rural Development Banks (SCARDBS)
Primary Cooperative Agricultural and Rural Development Banks (PARDBS)

The Cooperatives provide short term and medium term credit. There are agricultural and non agricultural credit societies. There are primary agricultural credit societies functioning in villages. There are urban banks and other non agricultural credit societies functioning in towns and cities. In addition there are farmer's service societies and grain banks. For providing long-term agricultural credit there are primary and central land development banks.

7.5 PRIMARY AGRICULTURAL CREDIT SOCIETIES :

Primary agricultural credit society forms the base in the three tier cooperative credit structure. It is a village level institution which directly deals with the rural people. It encourages savings among the agriculturists, accepts deposits from them, gives loans to the needy borrowers and collect repayments.

A Primary agricultural credit society may be started with 10 or more persons of a village. The membership is nominal so that even the poorest agriculturist can become a member. The members of the society may have unlimited which means that each member undertakes full responsibility of the entire loss of the society in case of its failure. The management of the society is under the control of an elected body.

The capital of the primary credit societies comes form their own funds, deposits borrowings and other sources. Own funds comprise of share capital membership fee and reserve funds Deposits are received from both members and non-members. Borrowings are mainly form central co-operative banks. It serves as the link between the ultimate borrowers i.e. the rural people on the one hand and the higher agencies i.e. Central Co-operative Bank, State Co-operative Bank and the Reserve Bank of India on the other hand.

Functions of PACS :

They provide not only short term loans but also medium term loans if necessary to the members.

1. It accepts fixed deposits from the public.
2. It provides credit loans to agriculturists and rural people.
3. It supervises the credit consumption.
4. It collects the loan amount from its members.
5. It repays the loans to Banks and financial institutions.
6. It provides credit to purchase agricultural instruments, fertilizers, pesticides and seeds.
7. They also help in marketing of agricultural produce.
8. It provides training facilities to members to adopt agricultural techniques.

There were nearly one lakh PACS existing as on march 31, 2001 with a membership of approximately 10 crore. As on the same date, outstanding deposits and loans of PACS were Rs.13,481 crore and Rs. 34,522 crore respectively. In a nut shell the fate of the very Co-operative movement depends greatly on the health and strength of the PACS. In spite of the Government efforts and support the working of the PACS and their health is far from satisfactory.

Defects of PACS :

1. They have failed to adequately fulfill the credit needs of the small farmers and tenants.
2. A large number of them lacked potential viability.
3. The Banking Commission (1972) observes that PACS neither provided credit for all productive activities of the farmers nor fulfilled their credit needs adequately.

Remedial Measures : The NABARD has recently stressed the need for a time bounding programme for improving the services to be recorded by the PACS. It has been suggested that the PACS should (a) Provide diversified credit facilities to their members (b) extending marketing facilities (c) mobilise rural deposits.

NABARD has been extending funds to develop the infrastructure of PACS.

7.6 Central Co-operative Banks :

The Central Co-operative Banks are federations of primary Credit Societies belonging to specific district. These banks are operating between primary cooperative banks and state Apex Cooperative banks. They are also called district central cooperative banks due to their jurisdiction in the area of operation. The Central Cooperative Banks manage their funds from sources like share capital, deposits, loans from State Cooperative Banks and other Commercial Banks.

Central Cooperative Banks are of two types :

a) There can be cooperative banking unions whose membership is open only to cooperative societies. Such cooperative banking unions exist in Haryana, Punjab, Rajasthan, Orrissa and Kerala.

b) There can be mixed Central Cooperative Banks whose membership is open to both individuals and Cooperative Societies. The Central Cooperative Banks in the remaining States are of this type.

Functions of Central Cooperative Banks :

The functions of Central Cooperative Banks are :

1. The main function of the Central Cooperative Banks is to provide loans to the primary cooperative societies. These serve as an important link between these societies at the base level and the money market of the country.

2. They accept deposits from public.

3. They grant credit to their customers on the security of first class gilt edged securities, gold etc.

4. They provide remittance facilities.

5. They act as balancing centres by shifting the excess funds of a surplus primary society to the deficit ones.

6. They keep watch on their debtor primary societies working and progress of recovery loans.

Capital : The Central Cooperative Banks raise their working capital from own funds, deposits, borrowings and other sources. In the own funds the major portion consists of share capital contributed by cooperative societies and the state government and the rest is made of up reserves. Deposits largely come from individuals,local bodies and cooperative societies. Deposit mobilisation by the central cooperative banks varies from state to state. Borrowings are mostly from Reserve Bank and Apex banks.

Loans and Advances : The number of Central Cooperative Banks in 2000-2001 was 367 and the total amount of loans advanced by them as on march 31, 2002 stood at Rs. 45,257 crore. About 98% loans are received by cooperative societies and about 75% loans are short term. Mostly the loans are given for agricultural purpose. About 80% loans given to the Cooperative Societies are unsecured and the remaining loans are given against the securities such as merchandise, agricultural produce, immovable property, government and other securities etc.

Defects of Central Co-operative Banks :

The following are the major defects of Central Co-operative Banks:

1. They violate the principle of cooperation by working on the online of commercial banks.

2. They do not appoint experts to examine the credit worthiness of the primary societies.

3. They combine financing and supervisory work together. As a result supervisory work has been failure in many cases.

4. Some Central Cooperative Banks have been utilising their reserve funds as working capital. This is not a very sound practice.

5. The Central Cooperative Banks charge very high interest rates to meet their high administration costs of small uneconomic units.

6. Many central cooperative banks are financially and organisationally weak.

7. Overdues are increasing day by day. This leads to bad debts which ultimately results in losses.

7.7 State Cooperative Banks :

State Cooperative Banks are the apex institutions in the three tier cooperative credit structure operating at the state level. Every state has state cooperative bank.

Functions :

The following are the major functions of the Central Cooperative Banks :

1. They provide loans to the central cooperative banks in order to enable them to help in promoting the lending activities of the primary credit societies. They save as the final link between the money market and the cooperative sector.
2. They act as a ‘balancing centre’ by balancing excesses and deficiencies in the resources of central cooperative banks.
3. In the absence of district cooperative bank in a state, the state cooperative bank may give direct financial assistance to the primary credit societies.
4. A SCB serves as a lender of cooperative movement in a state.
5. As a bank the SCB is expected to mobilise and create deposits for the benefit of cooperative credit movement and provide the essential banking services.
6. They finance, control and supervise the central cooperative banks and through them the primary credit societies.
7. They provide a link through the Reserve Bank of India provides credit to the cooperatives and thus participate in rural finance.
8. The SCB’s finance, coordinate and control the working of the central cooperative banks in every state.

Capital : State Cooperative Banks procure their working capital from its capital and reserves deposits from public and loans and advances form NABARD.

The capital is raised from members of cooperative societies including CCB's and the rest from state Government. The capital contributed by individuals is negligible. The deposits are largely held by cooperative societies.

1. State cooperative banks obtain their working capital from own funds i.e.deposits, borrowings and other sources.

   i) Own funds includes share capital and reserves. Major portion of share capital is raised from member cooperative societies and the central cooperative banks and the rest is contrib- uted by the state government. Individual contribution on the share capital is very small.

   ii) The main source of deposits is also the cooperative societies and central cooperative banks. The remaining deposits come from individuals, local bodies and others.

   iii) Borrowings of the state cooperative banks are mainly from the Reserve Bank and the remaining from state government and others.

Loans and Advances : SCBs are mainly interested in providing loans and advances to the cooperative societies. More than 98% loans are granted to these societies of which about 75% are for the short period. Mostly the loans are given for agricultural purpose.

Defects :

The following are major defects SCB's

1. They mix up commercial banking activities with cooperative banking.
2. They have insufficient share capital.
3. They utilise their reserve funds as working capital.

7.8 IMPORTANCE OF COOPERATIVE BANKS :

The cooperative banking system has to play a critical role in promoting rural finance and is specially suited to Indian conditions. Various advantages of cooperative credit institutions are given below :

1. The main objective of cooperative credit movement is to provide an effective alternative to traditional defective credit system of the village money lender. The cooperative banks tend to protect the rural population from the clutches of money lenders.
2. Cooperative credit system has cheapened the rural credit by charging low rates of interest.
3. Cooperative societies discourage unproductive borrowing.
4. Cooperative credit movement has encouraged saving and investment by developing the habits of thrift among agriculturists.
5. Cooperative societies have also greatly helped in the introduction of better agricultural methods, cooperative credit is available for purchasing improved seeds, chemical fertilizers, modern implements etc.
6. Cooperative banking system has a federal structure such banking structure is essential and particularly suited for effectively meeting the financial requirements of the vast rural areas of the country.

7.9 WEAKNESSES OF COOPERATIVE BANKING :

Various committees, commissions and individual studies that have reviewed the working of the cooperative banking system in India have pointed out a number of weaknesses of the system and have made suggestions to improve the system. Major weaknesses are given below :

1. The functioning of cooperative credit structure at the primary level suffers from inadequate coverage by the societies and ineffecient societies.
2. A serious problem of the cooperative credit is the overdue loans of the cooperative institutions which have been continuously increasing over the years. Large amounts of over dues restrict the recycling of funds and adversely affect the lending and borrowing capacity of the cooperative societies.
3. There have been large regional disparities in the distribution of cooperative credit.
4. Most of the benefits from the cooperatives have been cornered by the big land owners because of their strong socio-economic position.

7.10 REGIONAL RURAL BANKS :

The major objective of the rural credit policy in our country has undergone a radical change soon after independence. The Government decided to expand the role of institutional financing and curtail the role of money lenders. The All India Rural Credit Survey Committee opined that only multipurpose cooperatives could be a viable solution to the problem of rural finance. The SBI and the nationalised commercial Banks since (1969) made some efforts to improve rural finance. But the steps were nor adequate. The Banking Commission in its report in 1972 recommended the creation of ‘Rural Banks’.

In 1976, the parliament enacted the Regional Rural Banks Act, 1976 to provide for the incorporation, regulation and winding up of RRBs. The RRBs are scheduled commercial banks which are
in the second schedule of the RBI Act.

The main objective of the RRB was to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in the rural areas.

Functions of Regional Rural Banks :

The RRBs perform the following functions :

1. They provide credit facilities to agricultural sector with particular emphasis on small and marginal farmers and agricultural labourers.
2. They promote the welfare of economically and socially backward sections of the population.
3. They help the rural artisans and small enterpreneurs in rural areas by providing credit facilities.
4. Along with the agriculture, they are expected to help small business units and self employment schemes.
5. They mobilise deposits of rural people.

6. They provide subsidiary services like commercial banks.

Organisation and Structure of RRBs : As per section five of the Act, the authorised capital of each RRB shall be Rs. five crores. The issue / paid up capital minimum of Rs. 25 lakhs and maximum of Rs. 100 lakhs is to be contributed in the ratio of 50:15:35 by the Central Government, State Government and sponsoring commercial bank respectively.

As at the end of march 2002, the Government of India raised the issued share capital of 196 RRBs to Rs. 75 lakhs each, while the same for 20 RRBs was raised to Rs. 100 lakh. The paid up capital of all the 196 RRBs stood at Rs. 195.66 crore by the end of march 2001.

The RRBs are directed and managed by a Board of Directors. The Board of Directors consists of a chairman, three directors to be nominated by the Central Government and not more than two directors to be nominated by the sponsoring bank. The chairman is appointed by the Central Government and his term of offices does not exceed five years.

The Board of Directors consists of 9 members including chairman. The chairman is the officer of the sponsor bank and appointed by the Central Government. Among the directors 6 are nominated by the Central Government and 2 by a sponsor bank, and 1 by a respective State Government. The Central Government has the right to increase the number up to 15. The Board has to function according to Central Government in consultation with RBI.

Differences between RRB's and scheduled commercial banks.

The Regional Rural Banks are also scheduled banks. The RRB however, differs from a scheduled commercial bank in the following respects.

1. The RRB is deemed to a cooperative society for the purpose of Income Tax Act 1961.
2. The area of operations of the RRB is limited to a specified region to one or more districts in the concerned state.
3. The RRB grant loans and advances only to the small and marginal farmers, agricultural labourers, rural artisans and small enterpreneurs or small traders.
4. The RRB charges interest rates as adopted by the cooperative societies in the state.
5. If an RRB crosses the limit of 100 branches, it has to seek Reserve Banks Permission before going beyond 100 branches.
6. The RRB is a sponsored bank. It is sponsored by a scheduled commercial bank.

Progress of Regional Rural Banks :

1. Encouragement to Rural Development : In the rural areas, the banks have extended institutional credit. They there by reduced the grip of money lenders over farmers. They have been a great help and assistance to beneficiaries such as small and marginal farmers, agricultural labourers, SC and ST population, and other weaker sections and rural artisans. Under differential interest rate scheme, they have been assisting physically handicapped persons.

2. Branch Expansion : The number of branches of these banks stood at 14,473 by the end of the June 2002. About 84 percent of the branches of present 196 RRBs are in the rural areas.

3. Deposit Mobilisation : These banks have been able to mobilise more deposits than the cooperative banks. Total deposits increased from Rs. 1057 crores as on June 1985 to Rs. 43,220 crores by march 2001.

4. Loans and Advances : The credit facilities provided by these banks increased from Rs.10 lakhs in 1975 to Rs. 18,373 crores by the end of march 2002.

5. Encouragement for Self Employment Schemes : These banks are giving primary importance for self employment schemes. They are giving financial assistance under Integrated Rural Development Programme (IRDP) for rural youth.

6. Creation of Employment to locals : They are providing employment to locals, particularly subordinate staff are recruited from the area where their branches are operating.

Defects of Regional Rural Banks :

The Regional Rural Banks have successfully achieved their main objective of concentrating their credit facilities to the weaker sections of the rural society for productive purposes. But, these banks also suffer from certain weaknesses.

i) There has been a great disparity in the growth of the Regional Rural Banks.

ii) Many of the Regional Rural Banks are not economically viable . They have been continuously incurring losses for years together.

iii) There is also the serious problems of alarmingly high as well as growing over dues.

iv) The staff provided by the sponsor banks to RRBs does not possess that much skill and exper tise that are really needed for. They do not possess necessary rural management skill. There are no adequate training facilities for their staff.

v) There is severe competition from Commercial Banks either in respect of mobilising deposits or in rendering other banking services.

vi) Slow progress in lending activity :

The RRB's pace of growth in loan business is slow. For this the following reasons may be given:

i) There have been limited scope for direct lending by RRBs in their fields of operations.

ii) It is always difficult to identify the potential small borrowers and bank staff have been required to make special and sincere efforts in this regard.

iii) Most of the small borrowers do not like the bank formalities and prefer to borrow from the informal / indigenous sources of finance, such as money lenders.

iv) The anamolies in the Differential interest rate (DIR) scheme also posed a special prob lem to the RRB's. While the RRBs charge 14 percent interest, the commercial banks charge only 4 percent under DIR scheme in rural areas.

v) There is no effective link between the RRBs and PACS and the farmer's service societies.

vi) There is lack of coordination between officials of the district credit planning committees and the RRB's.

Despite these problems, the RRBs have been trying their level best to achieve their social objectives. They have succeeded in protecting their image of 'small mans bank'. They are infact development banks of the rural poor. They have been trying to fill regional and functional gaps in rural finance in our country.

7.11 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD) :

With the increasing role institutional credit in the integrated rural development of the country, a need was felt for a single broad based organisation which would not only extend adequate financial assistance to the various credit institutions of the rural areas but also provide guidance in all the matters concerning the formulation and implementation of rural development programmes. So far all such functions have been performed by the Reserve Bank of India and the Agricultural Refinance and Development Corporation (ARDC). In 1981, the Committee to review Arrangement for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up by the Reserve Bank of India, recommended the establishment of the National Bank for Agriculture and Rural Development (NABARD). The recommendation was approved by the Government and consequently NABARD came in to existence on July 12, 1982.

National Bank for Agricultural and Rural Development (NABARD) is a specialised financial institution. It is also called National Bank, NABARD is linked with the RBI in the sense that half of NABARD's share capital is being contributed by the RBI and the other half being contributed by Government of India.

OBJECTIVES OF NABARD : NABARD is an apex development bank in the country. Its main objectives are :

i) to support and promote agriculture and rural development.

ii) to provide credit for the promotion of small scale industries, cottage and village industries, handi crafts and other rural crafts.

iii) to secure prosperity of rural areas through promoting integrated rural development and support ing other allied economic activities in rural areas.

iv) to support all matters connected with rural development.

ORGANISATION AND STRUCTURE OF NABARD :

NABARD is managed by a Board of Directors comprising of 15 members which includes the chairman, Managing Director, two experts in Rural Economics, three experts from the cooperative and commercial banks, three sitting directors from the board of the RBI, three directors from the Government of India and two members representing the State Governments. The Board of Directors can constitute an Advisory Council.

The paid up capital of NABARD is Rs. 100 crore. It is contributed equally by the RBI and Government of India. The bank is also authorised to accept deposits for over a year from the central, state and local Governments, scheduled commercial banks etc. It can also borrow seeking the approval of the Central Government, foreign currency from any bank or institution in India or abroad.

FUNCTIONS OF NABARD : NABARD performs the following functions :

1. It functions as an apex institution. It takes up all the functions performed by the Reserve Bank of India with regard to rural credit.

2. It serves as refinancing agency for the institutions providing production and investment credit for promoting various developmental activities in rural areas.

3. It provides short term credit (upto 18 months) to state cooperative banks for seasonal agricultural operations, marketing crops, distribution of fertilisers and working capital requirements.

4. It gives medium term credit (for 8 months to 7 years) to State Co-operative banks and Regional Rural Banks for approved agricultural purposes.

5. It extends medium term and long term credit (up to 25 years) of investment schemes in agriculture of State cooperative banks, land development banks, Regional Rural Banks and commercial banks.

6. It provides long term loans (up to 20 years) to state government to for subscribing to the share capital of cooperative institutions.

7. It maintains a Research and Development :

   (a) to promote research in agricultural and rural development,
   (b) to formulate the programmes
   (c) to cover special activities.

8. It has the responsibility of inspecting Regional Rural Banks and Central and State Cooperative Banks.

9. It undertakes monitoring and evaluation of projects refinanced by it.

10. It coordinates the rural financing activities of all the institutions engaged in developmental work at the field level and maintains liason with Central and State Governments, the Reserve Bank of India and other institutions concerned with policy formulation.

WORKING OF NABARD :

NABARD is a single integrated organisation which looks after the credit requirements of all types of agricultural and rural developmental activities. Its performance in extending various types of financial assistance is as follows :

1. NABARD sanctioned short term credit limit of Rs. 7,169 crores in 2000-01 to State Co operative banks for financing seasonal agricultural operations.
2. NABARD sanctioned financial limit worth Rs. 267 crores in 2000-01 to State and Central Cooperative Banks for converting short term agricultural loan into medium term loans.
3. NABARD sanctioned longterm credit limits of Rs. 150 crore to State Governments for contribution to the share capital of cooperative institutions.
4. Under various schematic leading operations, NABARD provides refinance assistance to four agencies, namely State Land Development Banks, Scheduled Commercial Banks, Regional Rural Banks and State Cooperative Banks.

5. NABARD like ARDC, has continued the policy of agricultural investment in the less developed and under banked states i.e. U.P, Bihar, M.P, Rajasthan and Orissa.

6. NABARD also provides financial help to non-form activities with a view to promot integrated rural development.

7. NABARD started taking active part in organising and strengthening the cooperative credit structure of the country.

8. Every year NABARD provides financial assistance to number of banks from its Research and Development Fund.

9. Out of Rural Infrastructure Development Fund, loans will be given to the State Governments for financial rural infrastructure projects.

10. NABARD directed RRBs and Cooperative Banks to issue Kisan Credit Cards liberally.

7.12 SUMMARY :

Cooperative banks are governed by cooperative credit societies Act, 1904. Cooperative banking in India is federal in structure. After nationalisation of banks, Regional Rural Banks were encouraged to serve the rural sector. NABARD has been playing a significant role in strengthening and reorganising the cooperative structure in the country.

7.13 SELF ASSESSEMENT QUESTIONS :

Short Answer Questions :

1. Distinguish between cooperative banks and commercial banks.
2. Mention the main short falls of Primary Agricultural Credit Societies
3. State the functions of State Cooperative Banks.
4. Out line the functions of Regional Rural Banks.
5. What are the functions of NABARD.

Long Answer Questions :

1. Discuss the role of Co-operative Banks in providing Rural Credit in India.
2. Discuss the role of RRB’s in promotion and development of rural sector in India.
3. Critically examine the progress of RRB’s in India.
4. What is the Role of NABARD in rural development.

7.14 REFERENCE BOOKS

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2. Banking and Financial Systems - Mithani & Gordon

3. Banking and Financial Systems - A.R.Aryasri, V.V.Ramana Murthy.

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Lesson: 8

EXCHANGE BANKS

8.0 Objective :

This lesson explains the meaning and operations of exchange banks, reasons for their growth, criticism against their functioning and remedial measures called for. It concludes with outlining the role of Exim bank and Export credit Guarantee Corporation in financing exchange banks.

Structure

8.1 Introduction
8.2 Meaning of Exchange Bank
8.3 History of Exchange Banks
8.4 Functions of Exchange Banks
8.5 Criticism of Exchange Banks
8.6 Control over Exchange Banks
8.7 Participation of Indian Banks in Financing Foreign Trade
8.8 Export-Import Bank of India (EXIM Bank)
8.9 Export Credit Guarantee Corporation (ECGC) of India Limited
8.10 Summary
8.11 Self Assessment Questions
8.12 Reference Books

8.1 INTRODUCTION :

Exchange banks have made their mark in the Indian financial system through their specialised activities in dealing with foreign exchange at a time when India had large amounts of imports, it is the exchange banks that provide the corporate houses the much scarce foreign exchange with liberalisation and globalisatin policies, Government of India extended a warm welcome to all foreign banks to set up their branches in India.

8.2 MEANING OF EXCHANGE BANK :

Exchange Banks are those banks which deal with foreign exchange and have specialised in financing foreign trade. These banks are foreign banks and have their head offices located outside the country. Although the main business of these is financing foreign trade, they also perform normal commercial banking functions and thus compete with local commercial banks.

The Bank of Tokyo, the Charted Bank, The First National City Bank of Newyork, The Grindlays Bank, the Loyds Bank, the Mercantile Bank of India etc., are some of the prominent foreign banks which are presently operating in India.

8.3 HISTORY OF EXCHANGE BANKS :

Exchange Banks / foreign banks have been doing business in India since 1870. The exchange banks have exerted tremendous influence on the development of Indian joint stock banking and the growth of organised money market in India. They are primarily meant to provide finance to India's foreign trade. They also financed inland trade of the country. The foreign banks have been enjoying the monopoly position in the field of financing foreign trade.

The 40 foreign banks operating in India come from 21 countries. The branches are spread over 25 centres in 16 states / union terrritories. Twelve foreign banks have 367 ATM's located both at branches and off cities. In addition, as on June 2001, 24 banks from 12 countries had their representative offices in India of these 22 were in Mumbai and one each in New Delhi and Chennai.

8.4 FUNCTIONS OF EXCHANGE BANKS :

The following are the main functions of Exchange banks.

1. Financing of Foreign Trade : The main function of exchange banks is to finance foreign trade. There are two aspects of financing foreign trade :

i) Financing Exports
ii) Financing Imports.

i) Financing Exports : The procedure adopted by exchange banks for financing export trade is as follows : The Indian exporter draws for a period of 90 days and is called D.A bill (Documents on Acceptance Bill). These bills are sent by the exchange banks in India to the foreign countries. After its acceptance by the foreign importer, the bill is returned to the exporter who can either get it discounted with the exchange bank or keep it with him and get the payment within three months.

ii) Financing of Imports : The imports to India are financed through D.P. bills (Documents on payment bills) drawn by the foreign exporters to Indian importers. The exchange bank presents the D.P bill to the Indian importer for getting his acceptance. The shipping documents are given to the Indian importer only after the fullpayment is made or if the importer executes a trust deed in favour of the exchange bank under which exchange bank remains the owner of the goods till the payment of goods is made.

2. Financing Internal Trade : The exchange banks in India also finance internal trade. For this purpose, these banks have opened their branches in major commercial centres of the country.

3. Discounting of Bills : The exchange banks also deal in inland bills of exchange mostly used in domestic trade. The Reserve Bank provides finance to the banks in India against their promissory notes draws on these bills.

4. Other Banking Functions : The foreign banks also perform other commercial banking functions such as accepting deposits, advancing loans, providing remittance facilities etc,. They, thus compete with Indian banks.

5. Merchant Banking : Some exchange banks have opened merchant banking divisions to provide merchant banking services. The exchange banks have been doing a profitable business in the country. Their profit to income ratio is more than double that of the Indian commercial banks. The higher profitability may be attributed to their " nonfund" business such as commission, brokerage etc., Further, they mostly finance multinationals in India.

8.5 CRITICISM OF EXCHANGE BANKS :

The exchange banks have been generally criticised on the ground that they act against the Indian interest. The following are the major complaints against these banks :

1. Monopoly : The exchange banks enjoy almost monopoly position in financing foreign trade in India. In this way, they earn huge amount of money in the form of Commission, brokerage and insurance premia.

2. No Legal Restrictions : For several years they were not subject to legal restrictions or statutory obligations.

3. Discrimination against Indian Traders : These banks have discriminating attitude towards Indian traders. They offer D.A bills to the foreigners under which foreign importers can take possession of goods supply after accepting bills. On the other hand, the Indians are offered D.P bills under which the Indian importers can get possession of goods only after making payments.

4. Undeveloped Bill Market in India : The exchange banks due to their monopolistic position in the finance of foreign trade have split the money market in to European and Indian. The Indian exchange banks discount the export bills in the London discouunt market, while keep the import bills with themselves till the maturity period is over. This has restricted the growth of Indian insurance and shipping companies.

5. Encouragement to Foreign Companies : These banks have patronised the foreign insurance and shipping companies and generally force the Indian traders to use services of these companies.

6. Competition with Indian Banks : These banks have provided stiff competition to Indian Commercial in internal trade also. This had a discouraging effect on Indian banks.

7. Policy Formulation in Foreign Countries : The head offices of the exchange banks are in foreign countries. Therefore the policies of these banks are formulated in the foreign contries do not take in to consideration the Indian interest.

8. Secrecy about activities : Before the enactment of the Banking Regulation Act 1949, foreign banks have keeping complete secrecy about their policies and activities.

9. Lack of Social Contact : The managerial bodies of foreign banks do not have any close social contact with their customers. Hence mostly by relying on information supplied by their stafff, brokers. They usually give poor references about Indian firms to enquiries abroad.

10. Unfair Competition : They have entered into unfair competition with the Indian banks by attracting deposits in India by underquoting Indian banks.

8.6 CONTROL OVER EXCHANGE BANKS :

The Banking Regulation Act of 1949, has provided wide powers to Reserve Bank of India for regulating the growth and activities of foreign exchange banks in India. Some of the restrictions imposed on these banks are mentioned below :

1. The exchange banks are required to take a licence from the Reserve Bank of India to carry on their activities in the country.

2. The Government of the country where the exchange bank is incorporated should assure Government of India at the time of incorporation that its laws are not descriminatory against Indian Banks.

3. These banks are required to keep paid-up capital and reserves of Rs. 15 lakh with the Reserve Bank of India. If the bank has a branch in Mumbai or Kolkata, then the amount is Rs. 20 lakh. The deposits with the Reserve Bank can be maintained either in cash or approved securities.

4. These banks are required to maintain or invest in India atleast 75 % of the demand and time deposits of Indian branches.

5. These banks are required to deposit 20% of annual profits with the Reserve Bank.

6. The foreign exchange business of these banks is subject to the provisions of the Exchange Control Regulations.

7. The lending, advancing and investment policies of these banks are subject to the general con trol of the Reserve Bank.

8. These banks are required to submit the audited annual financial statement regarding their busi ness conducted in India.

9. In case of failure of an exchange bank, the Indian depositors and creditors of that bank shall hold the first charge on the amount deposited with the RBI. This measure is expected to protect the Indian depositors and creditor's interests.

Despite regulation of the activities of the exchange banks in India by the Reserve Bank, these banks continue to enjoy monopoly in the field of financing foreign trade. Some critics have demanded their natinalisation. But at the time of nationnalisation of commercial banks in India, these banks were not nationalised for the following reasons :

a) to prevent complications in the international relations;
b) to prevent adverse efffect on import of foreign capital
c) to avail the facilities of foreign trade as provided by these banks; and
d) to avoid retaliation and spirit of vengeance.

8.7 PARTICIPATION OF INDIAN BANKS IN FINANCING FOREIGN TRADE :

Indian Banks also operate as foreign banks in other countries. As on 31st March 2000, 95 branches of 9 Indian Commercial banks were operating in over 25 foreign countries. These branches are located at the major international centres like London, Singapore, Bahrain and Paris. The largest concentration of the Indian bank branches is in the U.K., U.S.A., Fiji., Kenya, U.A.E, Hong Kong, Mauritius and Singapore. Bank wise the largest number of branches are of Bank of Baroda, followed by the State Bank of India and Bank of India. These branches specialise in financing foreign trade and International banking. It is thus felt that Indian banks can play a significant role by participating increasingly in financing the country's foreign trade.

8.8 EXPORT-IMPORT BANK OF INDIA (EXIM BANK) :

The Export-Import Bank of India is a statutory Corporation. It is wholly owned by the Central Government under the Export Import Bank of India Act 1981. It took over the export finance functions of IDBI and began functioning on March 1st, 1982. It is the Principal financial institution in India to coordinate the working of institutions engaged in fincancing export and import trade. It finances, facilitates and promotes foreign trade in India. The establishment of the EXIM Bank meant a great relief to all Indian business men who were depending mostly on foreign exchange banks incorporated outside India for their foreign exchange requirements.

FUNCTIONS OF EXIM BANK : The EXIM Bank perform the following functions :

1. It provides direct financial assistance to Indian exporters.
2. It provides Refinance facilities to the Commercial Banks and financial institutions for their export and import financing
3. It has taken over the export-import financing operations of the Industrial Development Bank of India.
4. It provides Loans to Commercial Banks by Rediscounting short term Export Bills and Refi nance of Export Credit.
5. It also provides relending facility to overseas banks.

CAPITAL RESOURCES : Funds of EXIM Bank are provided by Government of India, R.B.I., and I.D.B.I. The Authorised capital of this bank is Rs.650 crores(by March 2002). It can borrow funds from Government and Reserve Bank of India. It can raise funds by issuing bonds and debentures. It can raise funds from International marketers.

MANAGEMENT : The Bank is managed by a 17 member board of Directors, with a Chairman and managing director as the Chief executive and full time director. The board consists of Representatives from Government of India, R.B.I., I.D.B.I, ECGC, Commercial banks and the exporting community.

The EXIM Bank support has given a fillip to the Commercial banks in India to increase their export credit. The establishment of the Export-Credit Guarantee Corporation of India (ECGC) which provides protection against losses in Exports has also enabled the exporters to get greater credit from the Bank.

8.9 EXPORT CREDIT GUARANTEE CORPORATION (ECGC) OF INDIA LIMITED :

In July 1957 the Export Risks Insurance Corporation was set up by Government of India. In 1964, it was named as Export Credit Guarantee Corporation Limited. In 1983, it was renamed as Export Credit Guarantee Corporation of India Limited.

Objectives of ECGC : The main objective of ECGC is to support and strengthen the export promotion in India by

a) Providing a range of credit risk insurance schemes to exporters against loss if any, in export of goods and services, and

b) offering guarantees to banks and financial institutions so that the exporters can get better facilities from them.

The Problems of Indian exporters and the Indian joint stock banks are now more or less directly addressed by the EXIM Bank and ECGC. It also reduced the dependence of exporters and importers on exchange banks.

8.10 SUMMARY :

Exchange banks have made their mark in the Indian Financial system through their specialised activities in dealing with foreign exchange. There is criticism against the exchange banks but remedial measures undertaken to achieve an effective control over the functioning of exchange banks. The exchange banks were integrated into Indian financial system through certain stipulations such as priority sector advances.

8.11 SELF ASSESSMENT QUESTIONS :

Short Answer Questions :

1. Exchange bank
2. D.P. Bill and D.A. Bill
3. EXIM Bank.
4. Letter of Credit.
5. ECGC.

Long-Answer Questions :

1. What are foreign exchange banks ? What is their place in Indian banking structure ?
2. State the functions of foreign exchange banks.
3. Evaluate the foreign exchange banks in financing foreign trade.

8.12 REFERENCE BOOKS / SUGGESTED READINGS :

1. Banking & Financial Systems	-	Mithani & Gordon
2. Banking & Financial Systems	-	A.V. Ranganadhachary, R.R.Paul
3. Banking & Financial Systems	-	A.R.Aryasri, V.V.Ramana Murthy.

- P. USHA RANI

Lesson : 9

DEVELOPMENT OF FINANCIAL INSTITUTIONS

9.0 OBJECTIVES : This lesson deals with the concept of development banking, structure, functions and growth of Development Financial Institutions in India. This also explains the objectives, structure, products and services and operational performance of IFCI, IDBI, ICICI, SIDBI, SFC etc.,.

Structure

9.1 Introduction
9.2 Meaning and Definition of Development Bank
9.3 Need for Development Banks
9.4 Features of Development Banks
9.5 Development Banks in India
9.6 IFCI
9.7 IDBI
9.8 ICICI
9.9 SIDBI
9.10 SFCS
9.11 Summary
9.12 Self Assessment Questions
9.13 Reference Books

9.1 Introduction :

In the field of industrial finance, the concept of development bank is of recent origin. In a country like India, the emergence of development banking is a Post-independence Phenomenon. When India attained independence, the Indian capital was relatively under-developed. There was demand for new capital. But there were no providers of finance. There were commercial banks but they were not adequately geared up to provide long term industrial finance. This was the background for the setting up of development of financial institutions in India.

9.2 Meaning and Definition of Development Bank :

Development banking refers to any banking activity primarily carried out with a mission to translate Government's Plan priorities in to realities. Development banks (also called development financial institutions) are set up to carry out development banking activity. Fundamentally a development bank is a term lending institution.

Development bank is essentially a multi-purpose financial institution with a broad development outlook. A development 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. A development bank is a development oriented bank.

9.3 Need for Development Banks :

Development banks are established to accelerate the economic development of developing economies.

1. Developing economies are unable to raise the required financial resources for the development.
2. In these countries, the rate of capital formation is low. Development banks help to reduce the gap between investment demand and saving availability.
3. In underdeveloped economies, capital market is not organised to cater to the development needs. Development banks help the dynamic growth of capital market.

9.4 Features of a Development Bank :

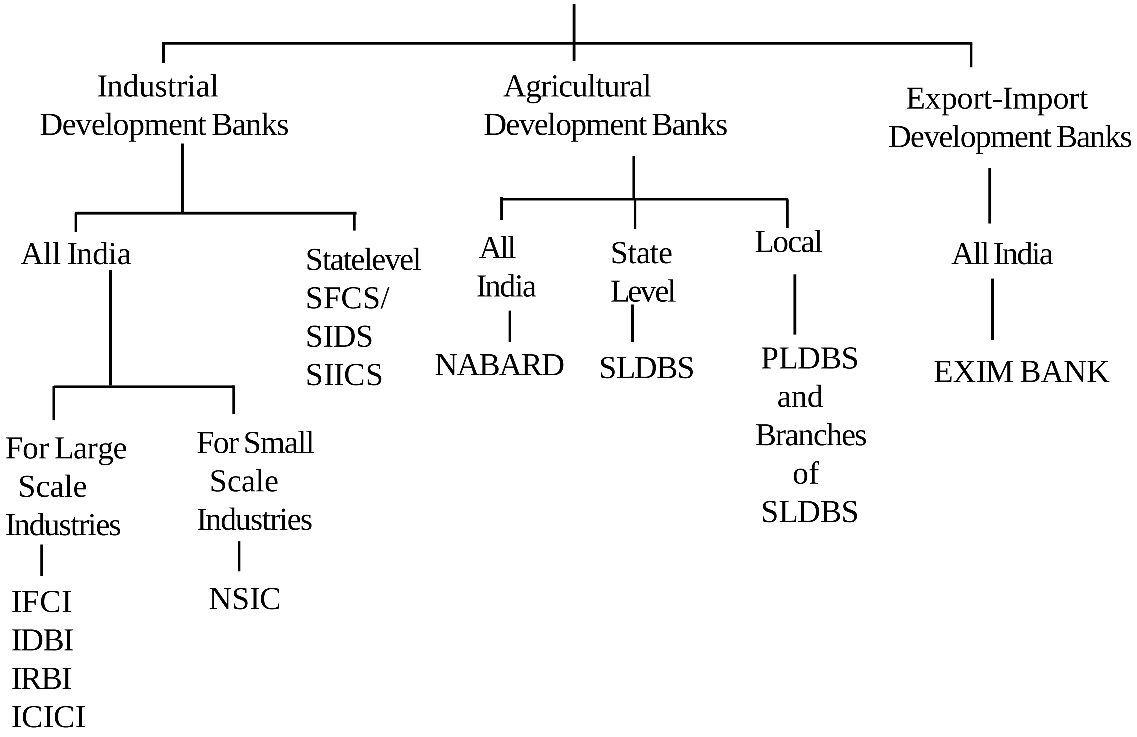
Following are the main Characteristic features of a development bank.

1. It is a specialised financial institution.
2. It provides medium and long term finance to business units.
3. Unlike commercial banks, it doesnot accept deposits from the public.
4. It is not just a term- lending institution. It is a multipurpose financial institution.
5. It is essentially a development oriented bank. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
6. It provides financial assistance not only to the private sector but also to the public sector undertakings.
7. It acts as underwriters for the issue of shares, bonds and debentures of industrial units.
8. It also renders technical advice and management consultancy services to assist the management of industrial units.

9.5 Development Banks in India :

Development banks in India may be classified into three groups
i) Industrial development banks
ii) Agricultural development banks and
iii) Export-import development banks.

Structure of Development Banks


Industrial Development Banks
Agricultural Development Banks
Export-Import Development Banks
All India
Statelevel SFCS/ SIDS SIICS
All India
State Level
Local
All India
NABARD
SLDBS
PLDBS and Branches of SLDBS
EXIM BANK
For Large Scale Industries
For Small Scale Industries
IFCI IDBI IRBI ICICI
NSIC

The LIC, the GIC and the UTI are the specialised forms of financial institutions in the capital market of India. They are distinct from the development banks, as they just play a role of providing industrial finance in the form of loans, underwriting and investment but do not have direct responsibility to promote industrial development.

9.5 THE INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)

The Industrial Finance Corporation of India (IFCI) was the first industrial development bank set up by the Government of India in July 1948. It was established to provide medium and long term credit to eligible industrial units in the country. It extends financial assistance to large and medium sized industrial units in both private and public sectors and also to cooperatives. As a development bank, the IFCI also undertakes a number of promotional activities, some on its own and others jointly with other All-India financial institutions.

Functions : The following are the major functions of the IFCI.

i) It grants loans and advances to industrial concern both in rupees and foreign currency repayable with in 25 years. The limit of assistance to any single concern now is Rs. 1 crore under special circumstances the limit can be raised with the permission of the Government.

ii) It subscribes to the shares and debentures issued by the industrial concern.

iii) It underwrites the issues of stocks, shares, bonds, debentures of the industrial concern subject to the condition that such shares, stocks etc., are disposed of by the corporation with in a period of 7 years from the time of acquisition.

iv) It guarantees - a) rupees loans raised from scheduled banks or state co-operative banks by the industrial concerns, b) foreign currency loans raised from foreign institutions and c) deferred payments in respect of machinery imported from abroad or purchased from with in the country.

v) In recent years the corporation has started taking interest in the promotional activities such as organising techno-economic surveys, setting up of technical consultancy organisation etc.

Capital : The Capital resources of the IFCI comprise of :

a) Share capital and reserves
b) Bonds and debentures
c) Public deposits and
d) Other borrowings.

The corporation started with the authorised capital of Rs.10 crores and now it is 50 crores. The paid up capital was Rs.5crore to start with, on March 1998 it was Rs.453 crore. The Industrial Development Bank of India (IDBI) accounts for 50 percent of the share capital of the corporation. The remaining part is contributed by the scheduled commercial banks, insurance companies, investment trust and cooperative banks. The corporation has also built up sizable reserves.

Operational Performance of IFCI :

For ensuring greater flexibility and an ability to respond to the needs of the changing financial system, IFCI which was a statutory corporation earlier, became a registered company in 1993.

IFCI provides longterm develoopmental assistance to the Indian industry especially traditional sectors like jute, textiles, sugar, iron and steel. Its contribution towards modernisation of Indian industry, export promotion, import substitution, entreprenuership development, pollution control, energy conservation and generation of both direct and indirect employment has been note worthy. The sectors that have benefited from IFCI disbursements include :

- the consumer goods industry (textile, paper, and sugar)
- the service industry (hotels and hospitals)
- basic industries (iron and steel, fertilizers, basic chemicals and cement)
- capital and intermediate goods industries (electronics, synthetic fibres, plastics)
- infrastructure (power generation and telecom services)

The IFCI has the credit of promoting institutions such as

* Management Development Institute (MDI) for management training and development.

* ICRA for credit rating

* Tourism and Finance corporation of India (TFCI) for promotion of hotel and tourism industry.

* Institute of Labour Development (ILD) for rehabilitation and training of displaced and retrenched labour force.

* Rastriya Gramin Vikas Nidhi (RGVN) , an important voluntary agency to pro mote, support and develop voluntary agencies engage in socio-economic upliftment of rural and urban poor in East and Nort Eastern part of India.

Contribution to Indian Capital Market :

IFCI has also promoted the following organizations which plays a key role in Indian capital markets today.

* stock holdingcorporation of India Ltd (SHCIL)

* Discount and Finance House of India Ltd (DFHI)

* National Stock Exchange (NSE)

* Over the counter Exchange of India (OTCEI)

* Securities Trading Corporation of India (STCI)

* LIC Housing Finance Ltd.

* GIC Grih Vitta Ltd.

9.6 THE INDUSTRIAL DEVELOPMENT BANK OF INDIA :

The Industrial Development Bank of India is the apex financial institution in the field of development banking in the country. It was established in July, 1964 as a wholly owned subsidiary of the Reserve Bank of India. It was given complete autonomy in February 1976. It was mainly established to meet the growing financial needs of rapid industrialisation in the country and to coordinate the acitivities and assisting the growth of all institutions engaged in financial industries.

Functions : The main functions of the IDBI may be stated as follows :

1. The IDBI provides direct financial assistance to industrial concerns in the form of
   a) granting loans and advances
   b) subscribing to purchasing or underwriting the issue of stocks, bonds or deben tures.

2. The IDBI provides indirect financial assistance to the small and medium industrial concerns through other financial institutions such as state finance corporations, state Industrial development Corporations, Co-operative Banks, Regional Rural Banks and Commercial Banks. The assistance to these institutions include :

a) refinancing of loans given by the institutions;
b) subscribing to their shares and bonds;
c) rediscounting of bills.

3. The creation of the Development Assistance Fund is the special feature of the IDBI. The Fund is used to provide assistance to those industries which are not able to obtain funds in the normal course mainly because of heavy investment or low expected rate of returns. The financial resources of the Fund mainly come from contributions made by the Government in the form of loans, gifts, donations etc., and from other sources.

4. IDBI also undertakes various promotional acitivities such as marketing and investment reserve, techno-economic surveys.

5. It provides technical and administrative advice for promotion, expansion and better management of the industrial concerns.

Capital : Initially the authorised capital of the IDBI was Rs.50 crores. Now it has been raised to Rs. 500 crores; it can further be raised to the amount not exceeding Rs. 2000 crore. The major sources of finance of the Bank are share capital, reserves, borrowing from Reserve Bank and the Government, and bonds and debentures. Funds are also raised through deposits from companies and through investments.

Operational Performance of IDBI :

The IDBI has been playing a leading role in providing direct loans to the industrial concerns, extending refinancing facilities for industrial and export credit, subscribing to and the underwriting of the shares, bonds and debentures of the industrial concerns and accepting, discounting and rediscounting the commercial bills of the industrial concerns.

* The direct assistance to the industrial concerns over the years has accounted for about one third of the total assistance. IDBI sanctioned a total assistance of Rs.16034 crore in 2001-02. The disbursements during this period amounted to Rs 11,158 crores.

* IDBI provides financial assistance both in rupee and foreign currency for greenfield projects, expansion, modernisation and diversification purposes.

* IDBI also provides indirect financial assistance through refinancing of loans extended by primary financial institutions and by way of rediscounting of bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

* IDBI has also been providing merchant banking and a wide array of corporate advisory services as a part of its fee based activities. These include professional advice and services for issue management, private placement of equity/ debt instruments, project evaluation credit syndication, share valuation, corporate restructuring including mergers and acquisitions, and disinvestment of equity.

- The bank also offers a number of for ex - related services on a commission basis, including opening of letters of credit and remittances of foreign currency on behalf of its assisted companies for import of its goods and services.

- IDBI developed the following financial institutions, capital market related agencies and training institutes.

Financial Institutions :

* IDBI Principal Asset Management Company Ltd
* EXIM Bank Ltd.
* Small Industries Bank of India (SIDBI)
* North Eastern Development Finance Corporation Ltd (NEDF)

Capital Market Related Agencies :

* Securities and Exchange Board of India (SEBI)
* National Stock Exchange of India Ltd (NSE)
* Stock Holding Corporation of India Ltd (SHCIL)
*Credit Analysis and Research Ltd (CARE)
* IDBI Trusteeship Services Ltd (ITSL)
* Clearing Corporation of India Ltd (CCIL)

- The IDBI has shown special interest in extending assistance to small scale industries through its refinance scheme. In may 1986 the IDBI has set up a small fund called Small Industries Development Fund (SIDF) to facilitate development, expansion, modernisation diversification and rehabilitation of small industries. The IDBI has also introduced the Integrated Term loan facility for the new small projects. After the establishment of small industries Development Board of India (SIDBI), the entire portfolio of IDBI relating to small and tiny sector has been transfered to SIDBI from April 1990.

- The IDBI has been providing financial as well as non financial assistance to promote industries in the backward regions of the country. The non financial assistance in the form of indentification formulation of viable projects, the provision of technical assistance etc.,

- The IDBI introduced the soft loan scheme for providing concessional finance to the selected industries like cement, jute, sugar, cotton, textiles and certain engineering industries for modernising, replacing and renovating their plants and equipment.

- The IDBI has introduced a special scheme for no industry district with a view to develop industries in these districts by providing financial, technical and administrative assistance and arranging training for potential entrepreneurs. The IDBI conducts surveys to study the industrial potential of no industry districts.

- The IDBI has also initiated the Technical Consultancy Organisation (TCO). The main objective of this organisation is to organise feasibility studies, project appraisals, industrial and market potential surveys and training programmes for new entrepreneurs.

9.8 THE INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI) :

The Industrial Credit and Investment Corporation of India (ICICI) was established in 1955 as a private sector development bank to assist and promote private industrial concerns in the country. Its entire share capital was contributed banks, insurance companies, foreign institutions and world bank. The objectives of the ICICI are a) to assist in the creation, expansion, and modernisation of private concerns; b) to encourage the participation of internal and external capital in the private concerns; c) to encourage private ownership of industrial investment.

FUNCTIONS : The ICICI performs the following functions :

1. It provides long term and medium term loans in rupees and foreign currencies.
2. It participates in the equity capital of the industrial concerns.
3. It underwrites new issues of shares and debentures.
4. It guarantees loans raised by private concerns from other sources.
5. It provides technical, managerial and administrative assistance to industrial concerns.
6. It provides foreign currency loans for payment of imported capital equipment and technical services.
7. It provides merchant banking services.
8. It extends credit facilities to indigeneous manufacturers for promoting sale of industrial equipment on deferred payment terms.
9. It renders project counselling for non-resident Indians.
10. It provides advice on risk management related issues.

CAPITAL : Initially, the corporation started with the authorised capital of Rs.25 crore. At the end of June 1986, the authorised capital was Rs.100 crore and the paid-up capital was Rs. 49.5 crore. Various sources of financial resources of the corporation are Indian banks, insurance companies and foreign institutions, including the World Bank, and the public. The Government and the IDBI have also provided loans to the Corporation.

The performance of the ICICI in the field of financial assistance provided to the industrial concerns has been quite satisfactory. Over the years, the assistance sanctioned by the corporation has grown from Rs.14.8 crore in 1961-62 to Rs. 43.0 crore in 1970-71 and Rs. 44478.8 crore in 1999-2000. Similarly the amount disbursed has increased from Rs. 8.6 crore in 1961-62 to Rs. 29.8 crore in 1970-71 and to Rs. 25835.7 crore in 1999-2000.

ICICI has been providing special attention to financing riskier and non traditional industries such as chemicals, petrochemicals, heavy engineering and metal products. ICICI has also been providing assistance to the small scale industries and the projects in backward areas. In 1977 the ICICI promoted the Housing Developoment Finance Corporation Ltd to grant term loans for the construction and purchase of residential houses. Since 1983, the ICICI has been providing leasing assistance for computerisation, modernisation and replacement schemes for energy conservation; for export orientation; for pollution control; for balancing and expansion etc.,

Today, Industrial Credit and Investment Corporation of India (ICICI) as a development financial institution no more exists. It has been merged with ICICI bank to emerge as a universal bank. ICICI has illustrious record of five decades of contribution to the economic and industrial development of the country.

9.9 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI) :

The Small-Scale Sector in India forms the backbone of the Indian economy. The number of SSI units is estimated to have increased to around 35 lakh units as on March 2002. The Small Industry has certain strengths such as flexibility adaptability, inventiveness and innovativeness when compared to large industry. Inspite of such strengths, the small scale sector badly requires nuturing and support through a conductive environment and strong support mechanisms so that it can realise its full potential. SIDBI has rightly extended the much needed support to small industry across the country.

Small Industries Development Bank of India (SIDBI) was established as wholly owned subsidiary of Industrial Development Bank of India (IDBI) under the small Industries Development of India Act, 1989. It is the principal financial institution for promotion, financing and development of industries in the small scale sector. It is also responsible for coordinating the branches of other institutions engaged in similar acitivities. Initially it was a refinancing organisation. The SIDBI is also responsible in administering the Small Industries Development Fund and National Equity Fund.

Functions :

SIDBI provides assistance to the Small Scale Industries Sector in the country through the existing banking and other financial institutions such as, State Financial Corporations, State Industrial Development Corporations, Commercial Banks, Co operative banks and RRB's etc., The major functions of SIDBI are :

1. SIDBI provides direct finance to beneficiaries under different schemes such as project financing, equipment financing, infrastructure financing and bills discounting schemes.

2. SIDBI provides indirect assistance to the intermediaries of banks and State level institutions mainly through refinancing and rediscounting. These intermediaries in turn provide financial assistance to the beneficiaries.

3. SIDBI provides seed capital / soft loan assistance under National Equity Fund and other schemes through specified financial institutions.

4. SIDBI renders financial support to National Small Industries Corporation for providing, leasing hirepurchase and marketing support to industrial units in the Small Scale Sector.

5. SIDBI provides support services such as finance, training, applicationn / sourcing of new technology and market information and advice to enhance the inherent strenght of SSI units and employment generation / economic rehabilitation of rural poor.

6. SIDBI copromotes state level venture funds in association with respective state Governments.

7. SIDBI finances projects relating to transport, health care and tourism sectors and also to the professional and self employed persons setting up of small sized professeional ventures.

Capital :

SIDBI started its operations from April 1990 with an initial authorised capital of Rs. 250 crore, which could be increased to Rs. 1000 crore. It also took over the outstanding portfolio of IDBI relating to small scale sector held under Small Industries Development Fund as on March 31st 1990 worth over Rs. 4000 crore. Presently the share holders of SIDBI include 35 banks, insurance companies investment and financial institutions in addition to IDBI.

Operational Performance of SIDBI : SIDBI plays a key role in implementation of Government policies and initiatives for the sector. It facilitates creation of an environment for self- sustaining and growing SSI units. SIDBI promoted the institutions include:

a) SIDBI Venture Capital Ltd
b) Credit Guarantee Fund Trust for Small Industries.
c) Technology Bureau for Small Enterprises.
d) SIDBI Foundation for micro credit.

SIDBI is one of the professionally managed organisation with considerable emphasis on corporate Governance. SIDBI was ranked 25 th position both in terms of capital and assets among all development banks of the world. SIDBI has been operating, schemes like single window scheme, composite loan scheme to ensure that financial assistance is made available to such units on easy terms. SIDBI provides developomental and support services to SSI under its promotional and developmental schemes. These schemes are oriented to serve rural enterpreneurs and youth, particularly women through programmes to empower them and motivate them to undertake enterpreneurial ventures.

9.10 STATE FINANCIAL CORPORATION (SFCS)

State Financial Corporations (SFCS) are set up under State Financial Corporations Act, 1951 with a principal objective of meeting the credit needs of medium and small scale industries located in backward areas in different states in the country. The main purpose of SFC s is to induce industrial activity in the entire country including backward regions. The industrial units located in backward regions are given special treatment in terms of concessional rates of interest, lower margins, reduces service charges, preferential sanction and disbursements of loans and so on. By the end of March 2002, there are 18 SFCS.

Functions : Various functions and types of financial assistance to be provided by the SFCS are given below :

i) The SFCS have been established to provide long-term finance to small scale and medium sized industrial concerns organised as public or private companies, corpora tions, partnership or property concerns.

ii) The SFCS extend loans and advances to industrial concerns repayable with in a period of 20 years.

iii) The SFCS guarantee loans raised by the industrial concerns in the market or from scheduled or cooperative banks and repayable with in 20 years.

iv) The SFCS underwrite the issue of stocks, shares, bonds and debentures by industrial concerns.

v) The SFCS guarantee the deferred payments for the purchase of plant, machinery etc., with in the country.

vi) The SFCS subscribe to the debentures of the industrial concerns repayable with in a period of 20 years.

vii) The SFCS guarantee loans raised by the industrial concerns from scheduled or cooperative banks and repayable with in 20 years.

viii) The SFCS are prohibited from subscribing directly to the shares or stock of any company having limited liability, except for under-writing purposes, and granting any loan or advance on the security of own shares.

ix) The SFCS can act as agent of the Central or State Government or some industrial financing institution for sanctioning and disbursing loans to small industries.

Capital : The capital resources of the SFCS include :

a) share capital and reserves
b) bonds and debentures
c) borrowing from the Reserve Bank, the State Governments
d) finance from Industrial Development Bank of India and
e) deposits.

The share capital of SFC is to be fixed by the concerned State Government subject to the limits between Rs. 50 lakh and 5 crore. The shares of the SFCS can be subscribed by the State

Governments, the Reserve Bank, Commercial Banks, Co operative banks, Other financial institutions and the public. The SFCS can also raise funds by issuing bonds and debentures. Bonds and debentures issued by the corporation are guaranteed by the respective State Governments and mostly subscribed by the Commercial Banks and other financial institutions.

Operational Performance of SFC :

At present there are 18 SFCS in the country. In 2000-01, the loans sanchtioned by the SFCS amounted to Rs. 1980.6 crore as against Rs. 13.3 crores in 1961-62 and Rs. 49 crore in 1970-71.

- The SFCS were set up with objective of providing financial assistance to small as well as medium industrial concerns. Though there has been a notable rise in the over all financial assistance, the performance in individual corporations differed largely due to the attitudes and motivations of the local enterpreneurs in different states.

- Prior to 1966, the SFCS showed preference for medium industries. But now there has been a marked shift in their lending policies infavour of the small units.

- Major beneficiaries of the financial assistance of the SFCS have been the food processing industries, services, chemicals, textiles, metal products, machinery and transport, equipment industries.

- The SFCS provide concessional assistance to the industrial units located in backward areas in terms of soft loans at concessional rates, lower margins, reduced service charges etc.,

- In order to encourage self-employment, the SFCS have formulated schemes of asstance to technician-entrepreneurs.

It has been observed, however, that there has been uneven development of industries with SFCS assistance in different states and regions. Thus the SFCS have failed to bring about a regional balanced growth of industries in a proper order. They have also favoured many large scale industries rather than small and medium industries in providing their assistance. It is therefore suggested that they should take greater care towards dispersal of industries in rural and backward areas. They should also support self-employment schemes and provide composite finance to the respective entrepreneurs.

9.11 SUMMARY :

Development Bannking refers to any banking activity primarily carried out with a mission to translate Government’s plan priorities in to realities. Development banks are established to make intermediate and long-term loans for the purpose of supporting economic development with in a country. Development financial institutions include IFCI, IDBI, ICICI, SFC, SIBDI etc.,.

9.12 SELF ASSESSMENT QUESTIONS :

Short Answer Questions :

1. What are the functions of development banks ?
2. State the objectives of SIDBI.
3. What are the functions of SFC’S ?

4. State the functions of IFCI.

5. Outline the structure of development banking in India.

6. Distinguish between commercial bank and development bank.

Long Answer Question :

1. Critically examine the role and functioning of Industrial Finance Corporation of India.

2. Critically evaluate the role of Industrial Development Bank of India in India's Industrial development.

3. What are financial Institutions ? Critically examine the working of any one of the finan cial institutions of your choice.

4. What are development of financial institutions? State the role of ICICI in providing development finance to industrial sector.

5. Explain the funcions of State Financial Corporations (SFCS)

6. What are the main sources of industrial finance in India..

9.13 REFERENCE BOOKS

1. Banking and Financial Systems	-	Mithani & Gordon
2. Banking and Financial Systems	-	A.V.Ranganadha chary, R.R.Paul.
3. Banking and Financial Systems	-	A.R.Aryasri, V.V.Ramana Murthy.

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LESSON - 10

INDIAN MONEY MARKET

10.0 Objective : This lesson explains the meaning and structure of Indian financial system, money market, its objectives and structure, its characteristics and weaknesses.

Structure

10.1 Introduction
10.2 Meaning and Definition of Money Market
10.3 Functions of Money Market
10.4 Constituents of the Money Market
10.5 Characteristics of Developed Money Market
10.6 Characteristic features of an under developed Money Market
10.7 The Structure of the Indian Money Market
10.8 Defects of Indian Money Market
10.9 Measures to Improve Indian Money Market
10.10 Role of Government in Money Market
10.11 Reserve Bank and Indian Money Market
10.12 Reforms in the Money Market
10.13 Summary
10.14 Self Assessment Questions
10.15 Reference Books.

10.1 Introduction :

The main function of financial system is to provide funds for financing operations relating to agricultural, industrial and services sectors and act as a catalyst for rapid economic growth and development. The essential components of financial system are money market and capital market that constitute life line of economy. The better these markets are organised, more rapid will be the economic development of the country. Both borrowers and lenders find it convenient to carry out their operations in an organised money market.

10.2 Meaning and Definition of Money Market :

Financial markets are functionally classified in to a) money market and b) capital market. Money market refers to institutional arrangements which deal with short-term funds. Capital market on the other hand deals in long term funds.

Money market is a short term credit market which deals with relatively liquid and quickly marketable assets, such as short term Government securities, treasury bills, bills of exchange etc., According to crowther “The money market is a collective name given to the various firms and institutions that deal with various grades of near-money”. 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.

The money market does not refer to any particular place. The transactions between borrowers lenders middlemen take place through telephone, telegraph, mail and agents. No personal contact between the two parties is essential for conducting the transactions.

10.3 Functions of Money Market :

1. It links lenders and borrowers of short term funds. It is purely a market for short term funds or financial assets.
2. It provides working capital requirements of industry trade and agriculture.
3. It provides financial assets with high degree of liquidity call money, treasury bills, com mercial bills etc.
4. By developing a bill market and acceptance market, it helps trade and commerce.
5. Treasury bill market enables the Government to raise short term loans.
6. The Central Bank controls and regulates the activities and functioning of financial institutions.
7. A well developed money market makes the monetary policy effective.
8. It provides opportunities for lending the surplus funds of individuals, banks and other institutions.

10.4 CONSTITUENTS OF THE MONEY MARKET

The money market is composed of several financial agencies that deal with different types of short-term credit. The important components of Money markets are :

i. Call Money Market
ii. Colleteral Loan Market
iii. Acceptance Market
iv. Bill Market.

i) Call Money Market : The market for extremely short period loans is referred to as the “call money market”. Bill brokers and dealers in stock exchange usually borrow money at call loans from the commercial banks. These loans are given for a very short duration, not exceeding 7 days. There are no colleteral securities demanded against these loans. The borrower has to repay the loans immediately they are called for. As such these loans are described as “call loans” or “call money” Interbank call money is very common in India.

ii) Collateral Loan Market : When loans are offered against collateral securities like stocks and bonds, they are called “colleteral loans” and the market is known as the colleteral loan market.

iii) Acceptance Market : It refers to the market for banker’s acceptances involved in trade transactions. A banker’s acceptance is a draft drawn by an individual or firm upon a bank ordering it to pay to the order of a designated party or to bearer a certain sum of money at a particular future date and this draft is accepted by the bank. Banker’s acceptances can be easily sold or discounted in the money market called the acceptance market.

iv) Bill Market : It is a market in which short term papers or bills are bought and sold. Bill market consists of a) commercial Bill market and b) treasury bills.

a) Commercial Bill Market : Commercial bills comprise bills of exchange and promissory notes. The commercial bills are very important source of short term finance to trade and industry. These bills of exchange are discounted and rediscounted by commercial banks to lend credit to the bill holder or to borrow from central bank.

b) Treasury Bills : Bills of exchange are commercial papers on the other hand treasury bills are Government papers. Treasury bills are short term Government security, usually of 91 days duration, sold by the Central bank on behalf of the Government. A particular aspect of treasury bills is that there is no prior rate of interest is fixed on them. The treasury offers these bills on the basis of competitive bidding. Thus one who bids the lowest interest will be alloted the bills.

10.5 CHARACTERISTICS OF DEVELOPED MONEY MARKET :

Developed money market is a relative term which refers to a better organised, more efficient and more sensitive money market. In other words, the developed money market has greater responsiveness to changes in demand and supply of short term funds in any of its segments. Generally the extent of development of a money market is closely related to the degree of economic development of a country. The following are the main characteristics of developed money markets.

1. Developed Banking System : A developed money market requires the existence of a well organised commercial banking system. Banks are the main channels of short term transaction. Moreover the public should also have banking habits. The various constituents of the money market must depend on commercial banks for accommodation.

2. Presence of Central Bank : An essential prerequisite for a developed money market is the presence of a central bank which functions as monetary and banking authority in the country. The central bank guides, controls and regulates the money market. The central bank is the lender of the last resort.

3. Availability of Financial Assets : Efficient working of the developed money market requires a regular and adequate supply of a variety of financial assets such as bills of exchange, treasury bills, short term Government bonds etc.,

4. Existence of Sub-Markets : Developed money market has well organised sub markets each specialising in a particular type of short-term asset, like bill of exchange, treasury bill or acceptance. “The larger the number of sub-markets the broader and more developed will be the structure of money market”.

5. Integrated Structure of Market : Developed money market has an integrated structure. Submarkets should be complementary to each other, besides being competitive.

6. Integrated Structure of Interest Rates : Another features of a developed money market is that interest rates prevailing in different sub-markets are integrated. A change in the bank rate by the Central Bank causes an equiproportional change in interest rates existing in different submarkets.

7. Availability of Adequate Resources : Another characteristic of a developed money market is the availability of adequate resources to finance the transactions in various sub-markets. This resources come from with in as well as outside the country. The London money market and the New York money market have access to domestic and foreign resources.

8. Existence of Specialised Institutions : The developed money market is characterised by the existence of institutions specialising in particular type of assets. These institutions help in increasing the efficiency of money market and making it more competitive.

9. Other Factors : There are many other factors contributing to the development of money market. They are : expansion of international trade, industrial development, stable political conditions, absence of discrimination against foreign firms etc.,

The lack of any of the above stated characteristics obviously makes a less developed money market and when these characteristics are totally absent or are found in an undeveloped state, the money market will be an underdeveloped money market.

10.6 The Characteristic Features of an Underdeveloped Money Market are :

i) It may have an unorganised commercial banking system.

ii) Its central bank may not be possessing adequate capacity and power to influence and control the entire money market.

iii) It is also characterised by the absence of adequate credit instruments and agencies.

iv) Its submarkets may be divided into water tight compartments and there is no close integrated link among them. Thus the money market structure may unorganised and uncoordinated.

v) Its monetary policy of the central bank may not work efficiently because of diversities in interest rates. The more unorganised the money market, the greater are the difficul ties of the central bank to exercise control over the banking system.

10.7 THE STRUCTURE OF THE INDIAN MONEY MARKET :

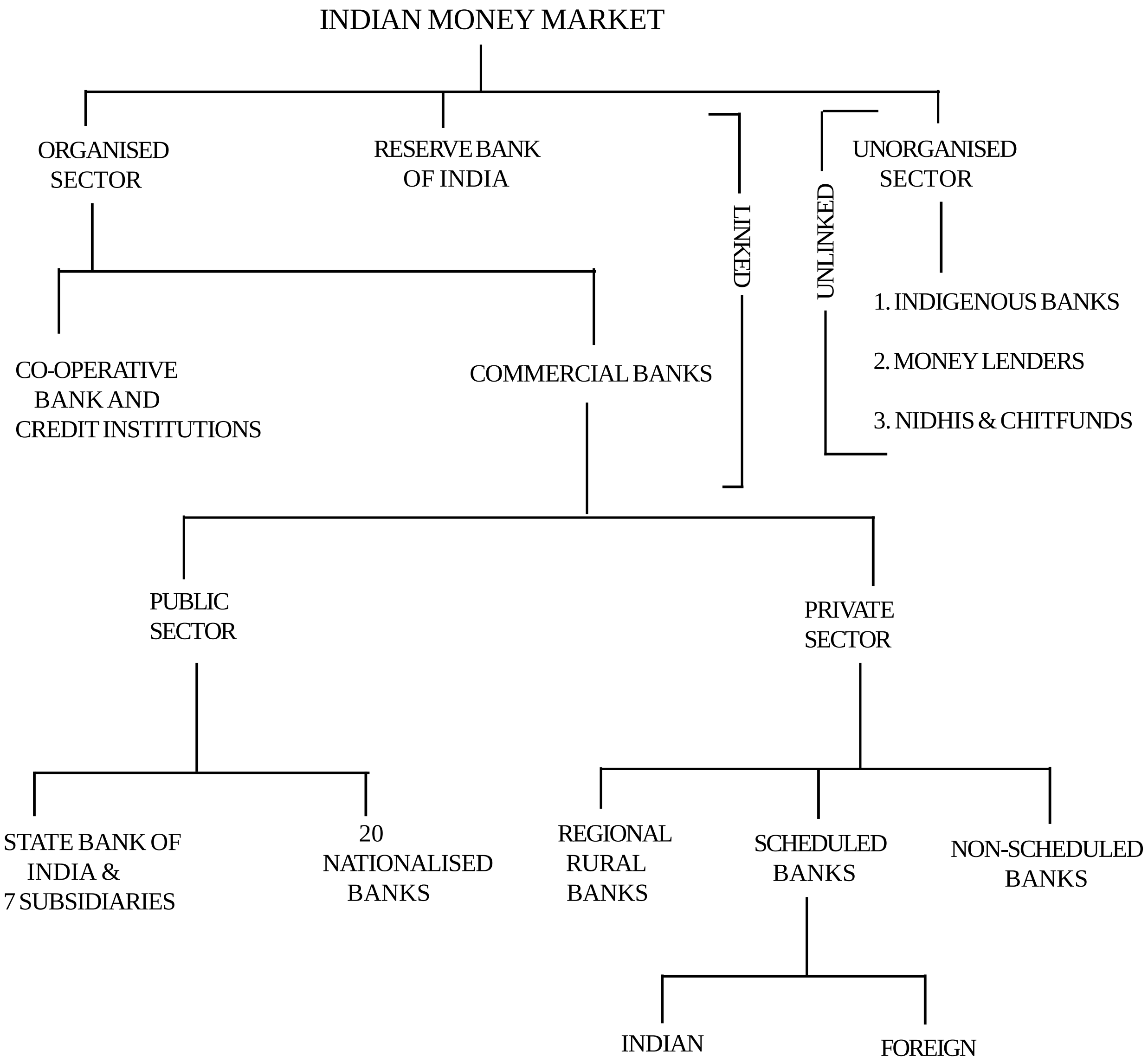
The Indian money market is composed of two categories of financial agencies:
i) Organised and ii) Unorganised.

i) The Organised Sector : The organised modern sector of Indian money market comprises a) the Reserve Bank of India b) the State Bank of India and its associate banks c) The Indian joint commercial banks (Scheduled and non-scheduled) of which 27 scheduled banks have been nationalised d) The exchange banks which mainly finance Indian foreign trade; e) Co-operative banks f) Other special institutions, such as IDBI, SFC, NABARD, EXIM Bank etc which operate in the money market indirectly through banks; and g) Quasi-Government bodies and large companies also make their funds available to the money market through banks.

ii) The Unorganised Sector : The unorganised sector comprise numerous indigenous bankers and village money lenders. It is organised because its activities are not controlled and co-ordinated by the Reserve Bank of India.

The organised and unorganised sectors are the two main sources of supply of short-term funds is the Indian money market. The main borrowers of short term funds are a) Central Government b) State Government c) Local bodies such as, muncipalities, village panchayats etc., d) traders, industrialists, farmers, exporters and importers, and e) general public.

STRUCTURE OF THE INDIAN MONEY MARKET


INDIAN MONEY MARKET
ORGANISED SECTOR
RESERVE BANK OF INDIA
LINKED
UNLINKED
UNORGANISED SECTOR
1. INDIGENOUS BANKS
2. MONEY LENDERS
3. NIDHIS & CHITFUNDS
CO-OPERATIVE BANK AND CREDIT INSTITUTIONS
COMMERCIAL BANKS
PUBLIC SECTOR
PRIVATE SECTOR
STATE BANK OF INDIA & 7 SUBSIDIARIES
20 NATIONALISED BANKS
REGIONAL RURAL BANKS
SCHEDULED BANKS
NON-SCHEDULED BANKS
INDIAN
FOREIGN

10.8 DEFECTS OF INDIAN MONEY MARKET :

A well-developed money market is a necessary pre-condition for the effective implementation of monnetary policy. The Central Bank controls and regulates the money supply in the country through the money market. But, unfortunately, the Indian money market is inadequately developed, loosely organised and suffers from many weaknesses. The major defects of Indian money market are :

1. Dichotomy : The most important defect of the Indian money market is its division into two sectors : a) the organised sector and b) the unorganised sector. There is little contact, coordination and cooperation between the two sectors. In such condition it is difficult for the Reserve Bank to ensure uniform and effective implementations of its monetary policy in both the sectors.

2. Dominance of Unorganised Sector : Another important defect of the Indian money market is its dominance of unorganised sector. The indigenous bankers occupy a significant position in the money lending business in the rural areas. The Reserve Bank has no control over the policies and functioning of the unorganised part of the money market which is quite large in size which plays in a significant role in rural finance.

3. Lack of Coordination : Wasteful competition exists not only between the organised and unorganised sectors, but also among the members of the two sectors. The relation between various segments of the money market are not cordial. They are loosely connected with each other and generally follow separatist tendencies.

4. Absence of All-India Money Market : Indian money market has not been organised in to a single integrated all-India money market. It is divided in to small segments mostly catering to the local financial needs.

5. Inadequate Banking Facilities : Indian money market is inadequate to meet the financial need of the economy. Although there has been rapid expansion of bank branches in recent years particularly after the nationalisation of banks, yet vast rural areas still exist with out banking facilities.

6. Too Many Interest Rates : The rate of interest charged in Indian money markets are too many too wide. For example, the rates of interest charged by indigenous bankers and money lenders are very high when compared to co-operative banks or scheduled commercial banks.

7. Shortage of Capital : Indian money market generally suffers from the shortage of capital funds. The availability of capital in the money market is insufficient to meet the industry and trade in the country.

8. Seasonal Shortage of Funds : A major drawback of the Indian market is the seasonal stringency of credit and higher interest rates during a part of the year.

9. Absence of Organised Bill Market : The bill market in India is also underdeveloped. In Indian money markets, many commercial transactions still take place in terms of cash. Cash credit is given by the banks against the security of commodities. There is lack of uniformity in drawing bills. Heavy stamp duty discourages the use of exchange bills. The Reserve Bank of India also prefers to extend rediscounting facility to the commercial banks against approved securities.

10. Scarcity of Credit Instruments : Till late 1980's, the Indian money market was suffering from scarcity of credit instruments. The only instruments available were the money at call and short notice and treasury bills. Moreover there were no specialists, dealers and brokers to handle the function in different segments of money market and to handle different kinds of credit instruments.

10.9 MEASURES TO IMPROVE INDIAN MONEY MARKET :

In view of the various defects in the Indian money market, the following suggestions have been made for its proper development.

i) The activities of indigenous banks should be brought under the effective control of Reserve Bank of India.

ii) Hundies used in the money market should be standardised and written in the uniform manner in order to develop an all India money market.

iii) Banking facilities should be expanded especially in the unbanked and neglected areas.

iv) Discounting and rediscounting facilities should be expanded in a bigway to develop the bill market in the country.

v) For raising the efficiency of the money market, the number of the clearing houses in the country should be increased and their working improved.

vi) Adequate and less costly remittance facilities should be provided to the businessmen to increase the mobility of capital.

vii) Variations in the interest rates should be reduced.

10.10 ROLE OF GOVERNMENT IN MONEY MARKET :

Government has a strategic role to play in money markets. It provides stability to financial institutions, money markets and capital markets by intervening in the interest rates and money supply. The Government can bring necessary changes in the interest rates and money supply through its fiscal policy and by guiding central bank to formulate appropriate monetary policies.

10.11 RESERVE BANK AND INDIAN MONEY MARKET :

The Reserve Bank and the Government as such are keen on removing deficiencies of the Indian money market. The Reserve Bank of India has taken various measures to improve the existing defects and to develop a sound money market in the country. The important measures taken by the Reserve Bank of India for the improvement of money market are :

1. The Reserve Bank of India has been making efforts to develop sound bill market and to encourage the use of bills in the banking system through the introduction of two schemes, one in 1952 and the other in 1970. The variety of bills eligible for use has also been enlarged.

2. A number of measures have been taken to improve the functioning of indigenous banks. These measures include : a) their registration b) keeping and auditing accounts c) Providing financial accommodation through banks.

3. The Reserve Bank is fully effective in the organised sector of money market and has evolved procedures and conventions to integrate and coordinate the different components of money market.

4. The difference between various sections of the money market has been considerably reduced. With the enactment of the Banking Regulation Act 1949, all the banks have been given equal treatment by the Reserve Bank as regards licensing, opening of branches, share capital, the type of loans to be given etc.,

5. In order to develop a sound money market, the Reserve Bank of India has taken measures to amalgamate and merge banks in to a few strong banks and given encouragement to the expansion of banking facilities in the country.

6. The Reserve Bank of India has been able to reduce considerably the different interest rates between different sections as well as different centres of the money market.

In 1986, the Reserve Bank of India set up a working group under the chairmanship of Mr. N.Vaghul to examine the possibilities of enlarging the scope of money market instruments. The working group submitted its report in January 1987. It has made a number of recommendations for activating and developing the Indian money market, some important recommendations are as follows :

1. Market forces to determine call money rates. The interest ceiling on call money fixed by Indian Banks association should be abolished and the call money rates should be left to be determined by market forces.
2. Payment through bills, to be made mandatory. The Government should make it manda tory for all credit purchases in the form of bills and these should be strictly honoured on due dates. The procedure for bills discounting should be simplified. Further rediscount ing by the institutions should be freely permitted.
3. Commercial paper (C.P) should be introduced, to start with, on a limited scale confining its access to only 'A' related companies. The interest rates on commercial paper should be freely determined by market considerations.
4. It should be ensured that the number of participants to bid regularly in the auction should be as large as possible to ensure an active secondary market in 182 Days Treasury Bill.
5. Inter-bank participation certificates should be reintroduced in a modified form.
6. The feasibility of introducing certificates of Deposits (CDs) may be considered at an appropriate time.
7. Banks and private non-banks institutions should be encouraged to provide factoring ser vices.
8. Stamp duty on bills should be abolished and commercial paper should be exempt from stamp duty.
9. An autonomous public limited company called the Finance House should be set up jointly by Reserve Bank of India public sector banks, and all India financial institutions to deal in money market instruments.
10. Suitable legislative measures should be under taken to give effect to various recommendations.

10.12 REFORMS IN THE MONEY MARKET :

As a part of meeting the emerging needs of the money market in the post liberalisation scenario and also in keeping with recommendations of vaghul working group, a series of reforms were introduced continously. The developments in the money market as a result of these reforms can be categorised in to the following groups.

1. New money market instruments.
2. New institutions, such as Discount and Finance House of India (DFHI) and Money Market Mutual Funds (MMMFs)
3. Supporting infrastructure through primary dealers and satellite dealers in the secondary market.

1. New Money Market Instruments : The following are new instruments introduced in the money market on the recommendations of vaghul working group :

a) Inter-Bank Participation (IBP) Certificates : There are modified form of participation certificates that were very popular during 1970's. IBP's are designed to even out short-term liquidity with in the banking system.

There are two types of IBP i) risk sharing basis, and ii) without sharing risk. IBPs with sharing could be issued for 91-180 days in respect of advances. The issuing bank and the participating bank are free to decide the rate of interest on such IBPs. IBPs without risk sharing are to be issued for a period not exceeding 90 days.

b) Treasury Bills of Different Maturity Periods :

i) 364- Days Treasury Bills : These were introduced in the year 1992 to widen and stabilise the money market. They are sold in auctions once in a month. These bills serve as innovative outlet for surplus funds. RBI does not provide rediscounting facility to these bills. They are known for their higher yield and safety and hence the response for these bills was satisfactory.

ii) 182-Days Treasury Bill : The interest on 182 Days Treasury Bills is variable. These are sold in auctions once in fortnight. They enjoyed high degree of liquidity as the yield was found to be very attractive.

iii) 14-Days Treasury Bills : From 1996-97, 14 Day Treasury Bill was introduced. The list of investors was confined to the State Governments, foreign Central Banks and specified bodies. The effective yield is fixed in such a way that it is equal to the rate of interest payable by the Central Government on ways and means Advances. The RBI introduced 14-Day Treasury Bill on weekly auction basis.

c) Commercial Papers (CPs) : Commercial Paper is an instrument issued for financing working capital requirements of corporate borrowers of commercial banks. It is an unsecured and short term negotiable instruments for raising short-term debt. CP is an innovative short-term financial instrument. It does not involve much documentation between the issuer and the investor. It dispenses with the intermediation of a banker in the process of raising funds from the market.

Commercial Paper may be issued in denominations of Rs. five lakh or multiples. They can be issued for maturities varying between a minimum of 15 days and a maximum up to one year from the date of issue. Commercial papers are issued only in dematerialised form.

i) Certificate of Deposits (CDs) : A certificate of deposit (CD) Shows that a deposit is made with a bank for a fixed period of time and it will be repaid with interest at the end of the maturity period. When an institution accepts a deposit, it is said to issue a CD. When it makes a deposit or buys a certificate in the secondary market, it is said to hold a CD. From the institution point of view, therefore, issued CD are liabilities and CDs held are assets. CDs are instruments for short-term, whole sale lending and borrowing. They can be issued for varying periods of maturity.

In order to bring CD on par with similar instruments like commercial paper, the minimum maturity period was reduced to fifteen days from April 2000. To give wider choice to both investors and issuers and to make the pricing of CDs more flexible, banks and financial institutions are allowed to issue CDs on floating rate basis.

e) Repos and Reverse Repos : Repo deal is a contract to buy securities and then to sell them back at a particular price and date. It is essentially an avenue for short-term investment of surplus of funds. Reverse Repo involves a contract to sell securities and then to repurchase it at a stated future date for a slightly higher price.

NEW INSTITUTIONS :

Discount and Finance House of India (DFHI) : Discount and Finance House of India (DFHI) was set up by RBI jointly with public sector banks and All India Financial Institutions in 1988. It was incorporated on March 8, 1988 under the companies Act, 1956 as joint stock company to deal in market instruments. The objectives of DFHI are as follows :

1. To balance the demand with the supply for short term finance in the money market.
2. To promote secondary market in short term money market.
3. To provide safe and risk free short term investment avenue to institutions.
4. To provide greater liquidity to money market instruments
5. To facilitate money market transactions for small and medium sized institutions who are not regular participants in the market.

Money Market Mutual Funds (MMMFs) :

MMMF is designed in 1992 to provide depth, stability and maturity to the money market and also to enhance returns on investments of individual investor. MMMFs can be set up both by public sector and private sector mutual funds. MMMFs invest exclusively in various money market instruments such as treasury bills, call and notice money, commercial paper and certificate of deposit.

SUPPORTING INFRASTRUCTURE :

Primary Dealers (PDs) : A system of primary dealers (PDs) was introduced in 1995 primarily to strengthen the infrastructure in the Government securities market including money market in order to make it vibrant, liquid and broad based. Primary dealers are the market players for Government Securities market operations and are regulated by Reserve Bank of India. Even subsidiaries of commercial banks and financial institutions dedicated predominantly to the securities business may act as primary dealers.

Discount and Finance House of India (DFHL) Limited, ICICI securities Limited, SBI Guilts Limited are some of the major primary dealers.

Satellite Dealers (SDs) : In order to strengthen the supporting infrastructure, a system of satellite dealers (SDs) was introduced to widen the scope for organised dealing and distribution arrangements in the Government Securities / money market instruments. SD play an active role in both primary and secondary segments of the Government securities / money market. They supplement the efforts of primary dealers in this direction.

To sum up, various steps taken by the RBI in view of the recommendations of the working Group to introduce reforms in the money market have changed the face of the money market in the country with so many reforms that have been introduced in the money market today's Indian money market, is more or less comparable to markets in advanced countries. In other words, Indian money market can no more be categorised as underdeveloped money market.

10.13 SUMMARY :

Financial Markets consist of money market and capital market. Money market is a market for short term funds. The money market in India constitutes organised banking and unorganised banking sectors. The important constituents of organised money market are a) RBI, b) SBI and its subsidiaries c) Nationalised banks d) Private sector banks e) Development banks such as IDBI, exchange banks, Central and State Cooperative banks etc. The unorganised money market consists of a) indigenous bankers b) money lenders c) Nidhis and chitfunds. Government Provides stability to money markets and capital markets by intervening in the interest rates and money supply.

10.14 Self Assessment Questions :

Short Answer Questions :

1) Define money market and bring out its features

2) What are the constituents of a money market

3) Distinguish between a money market and a capital market.

4) Outline the characteristics of a developed money market.

5) What is a commercial paper.

6) Distinguish between a commercial paper and certificate of deposit.

Long Answer Questions :

1) Distinguish between a developed money market and discuss the features of the Indian Money Market.

2) Describe the structure of Indian money market and point out its deficiencies. Suggest suitable measures to over come them.

3) Discuss the steps taken by the RBI in recent years to make the Indian money market a developed one.

10.15 Reference Books

1. Banking & Financial Systems	-	Mithani & Gordon
2. Banking & Financial Systems	-	A.V.Ranganadha Chary, R.R.Paul.
3. Banking & Financial Systems	-	A.R.Aryasri, V.V.Ramana Murthy.

- P.USHA RANI

LESSON - 11

INDIAN CAPITAL MARKET

11.0 OBJECTIVE :

This lesson explains the nature and scope of capital markets, activities in the primary and secondary markets, growth and development of capital market in India, capital market reforms, challenges to capital market, the concept, features, and the role of SEBI in regulating capital market. This lesson also explains the meaning of financial services, types of financial services and NBFCS.

Structure

11.1 Introduction
11.2 Meaning and Definition of Capital Market
11.3 Functions of Capital Market
11.4 Composition/ Structure of Capital Market
11.5 Gilt Edged Securities Market/ Government Securities Market
11.6 Industrial Securities Market/ Corporate Securities Market.
i) Primary Market
ii) Secondary Market
11.7 Stock Exchange
11.8 Functions of Stock Exchanges
11.9 Procedure of Transactions
11.10 Stock Exchanges in India
11.11 National Stock Exchange of India (NSE)
11.12 Over The Counter Exchange of India (OTCEI)
11.13 Stock Holding Corporation of India Limited (SHCIL)
11.14 Credit Rating Agencies
11.15 Securities and Exchange Board of India (SEBI)
11.16 Functions of SEBI
11.17 Capital Market Reforms
11.18 Primary Market Reforms
11.19 Secondary Market Reforms
11.20 Differences Between Money and Capital Market
11.21 Financial Services
11.22 Recent Trends in Financial Services
11.23 Merchant Banking
11.24 Loan Syndication
11.25 Leasing
11.26 Hire Purchase

11.27 Mutual Funds

11.28 Factoring

11.29 Forfeiting

11.30 Venture Capital

11.31 Bills Discounting

11.32 Non Banking Finance Companies :

a) Meaning of NBFCS

b) Functions of NBFCS

c) Growth of NBFCS

d) Control over NBFCS

11.33 Summary

11.34 Self Assessment Questions

11.35 Reference Books.

11.1 INTRODUCTION :

Capital market form the nerve centre of the industrial development of any economy. If they are transparent and vibrant, investors come forward to invest their surplus funds which can be channelised for the economic and industrial development of the country.

11.2 MEANING AND DEFINITION OF CAPITAL MARKET :

Capital market is a growing component of the financial system in India. “Capital market is the market for the financial assets that have long or indefinite maturity”. Capital market contains financial instruments of maturity period exceeding one year. It involves long term transaction capital markets are also called markets for corporate securities.

11.3 FUNCTIONS OF CAPITAL MARKET :

1. Transformation of Saving in to Investment : The function of capital market is transformation of savings into investment. It plays an important role in mobilising the savings and diverting them in productive investment.

2. Encouragement to Saving : With development of capital market the banking and non-banking institutions provide instruments which encourage people to save more.

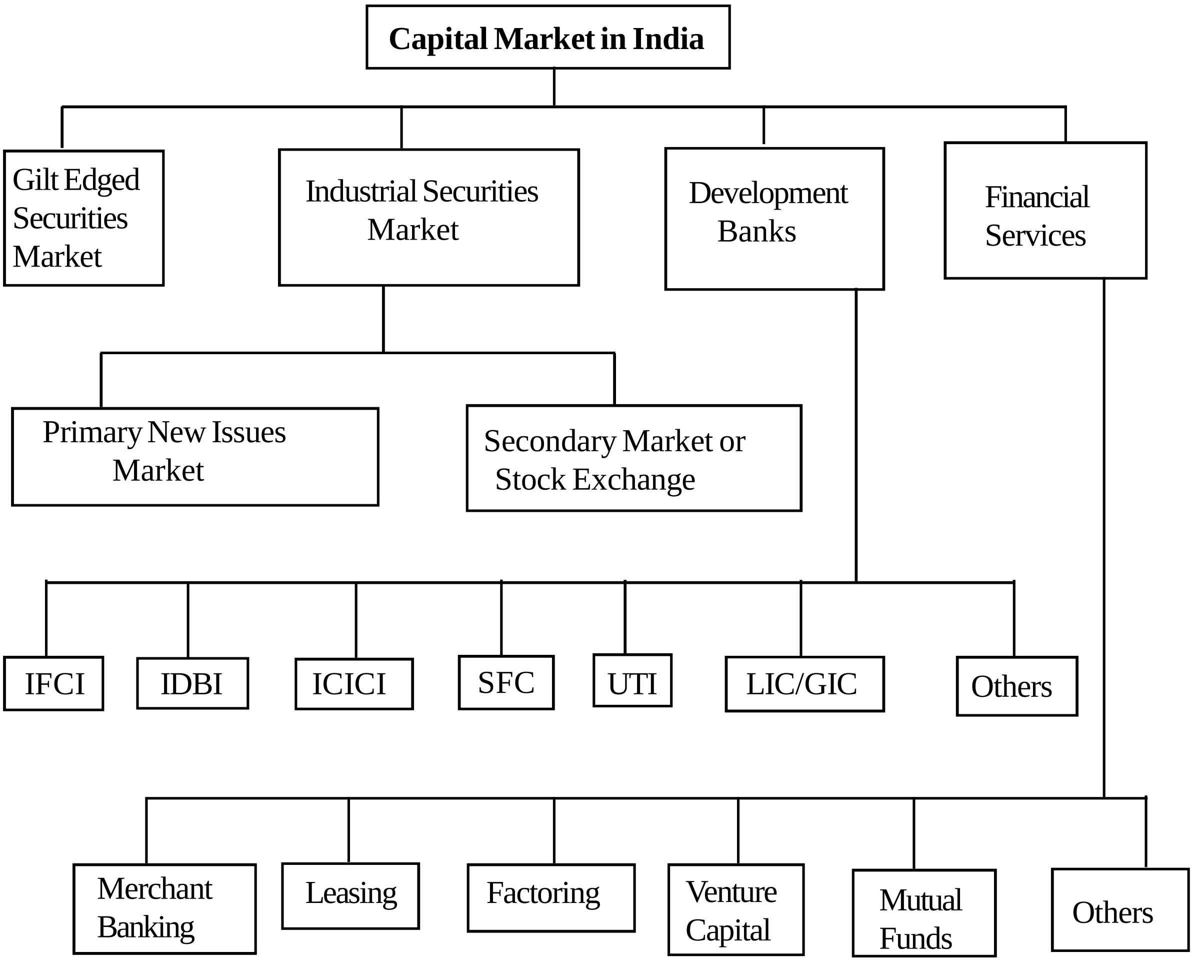
3. Encouragement to Investment : The Capital market facilitates lending to the businessmen and the government and thus encourage investment. It provides facilities through banks and non bank financial institutions. Various financial assets e.g. shares, securities, bonds etc induce savers to lend to the government or invest in industry.

4. Promotes Economic Growth : Various institutions of the capital market, like non bank financial intermediaries, allocate the resources rationally in accordance with the development needs of the country. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country.

5. Stability in Security Prices : The Capital tends to stabilise the values of stocks and securities and reduce the fluctuation in the prices to the minimum. The process of stabilisation is facilitated by providing capital to the borrowers at a lower interest rate and reducing the speculative and unproductive activities.

6. Benefits to Investors : The capital market helps the investors, i.e those who have funds to invest to long term financial assets. A healthy growth of capital market is therefore, essential to promote the savings and investments in the country.

11.4 COMPOSITION / STRUCTURE OF CAPITAL MARKET :


Capital Market in India
Gilt Edged Securities Market
Industrial Securities Market
Development Banks
Financial Services
Primary New Issues Market
Secondary Market or Stock Exchange
IFCI
IDBI
ICICI
SFC
UTI
LIC/GIC
Others
Merchant Banking
Leasing
Factoring
Venture Capital
Mutual Funds
Others

The Indian Capital Market is well diversified in terms of ownership pattern and structure. Capital market of India consists of :

11.5 1. Gilt Edged Securities Market / Government Securities Market :

The gilt edged market refers to the market for Government and Semi-Government securities, backed by the Reserve Bank of India. These securities guaranteed by the Government both for payment of principal and interest. These are the risk free securities. The following are the features of Government Securities :

a) Guarantee : There is guarantee for payment of both principal and interest with defined yield, at a given point of time.

b) Types of Government Securities : The Government Securities are of three types :

i) Long term	-	Exceeding 10 years
ii) Medium term	-	Ranging between 5-10 years
iii) Short term	-	1-5 years.

Government Securities are held in the form of :

- Stock Certificates
- Bearer Bonds.

Government Securities market can be categorised in to :

- New issues market
- Secondary market.

RBI is only authorised to deal with Government Securities. Government Securities are the most liquid debt instruments and each transaction in the Government securities market is so large that the amount will be in several lakhs & crores.

c) Types of Investors : The investors in the Government securities market are mostly the financial institutions such as LIC, Commercial Bank and Provident funds that have a statutory obligation to invest a certain portion of their funds in Government Securities.

11.6.2 INDUSTRIAL SECURITIES MARKET / CORPORATE SECURITIES MARKET :

Corporate Securities Market is a market where shares, debentures and bonds of joint stock companies (whether New companies / existing companies) are traded. Industrial Securities market or corporate securities market has been further divided in to :

(i) Primary (new issues) market

(ii) Secondary (old issues) market .

(i) Primary Market (New Issues Market) : The Primary Market is also called New Issues Market. It deals with the securities of new companies, new issues of established companies and also that of Government. Primary markets facilitates exchange of financial securities for long-term funds. A company may raise capital through primary market in any of the following ways :

(a) By Issuing Ordinary Shares : It is an ownership security. The investment in this capital instrument is permanent but highly liquid.

(b) By Issuing Preference Shares : It is an ownership security like an ordinary share, but carries a fixed rate of return. Preference shares may be - cumulative or non cumulative, convertible or non convertible, redeemable or non redeemable, participating or non participating.

(c) By Issuing Debentures : Debenture or bond is a creditorship security with a fixed rate of return, fixed maturity period, perfect income certainity and low-capital uncertainity. Deben tures may be registered, bearer, redeemable, perpetual, convertible, right, non-convertible, partly convertible.

Secondary Market (Stock Exchanges) : Secondary Market is an organised market for trading corporate securities. It is a market in which previously issued capital instruments are bought and sold. Although secondary market does not contribute directly to the supply of fresh capital, it does so indirectly by making the securities issued on the primary market more liquid. With regard to corporate securities, stock exchanges are the secondary markets.

11.7 STOCK EXCHANGE :

Stock Exchange is a market where stocks, shares and other securities are bought and sold. It is a market where the owners of securities can dispose them of as and when they desire. Stock exchange or stock market has both primary and secondary market segments.

Stock Exchanges facilitates the trading in secondary markets. One can buy and / or sell the securities of listed companies through a broker of a stock exchange. The Securities of Government organisations, local bodies such as municipalities, port trust and so on are also traded in the secondary market.

11.8 FUNCTIONS OF STOCK EXCHANGES :

A well-organised stock exchange performs a number of useful functions in an economy. Important among them are :

i) An organised stock exchange operating under the well-defined rule and regulations minimises the dangers of speculative dealings and price manipulations.

ii) Stock exchange provides a ready market for trading in securities and in this way capital is made more mobile.

iii) Stock exchange helps in determining the prices of securities.

iv) Stock exchange enables the business firms to raise large volumes of funds from the market.

v) Stock exchange increases the credit worthiness of the business enterprises. A com pany whose shares are listed in a stock exchange is considered to be a sound com pany.

vi) A competitive and efficient stock exchange acts as a barometer of business condi tions in the country.

vii) Stock exchange helps the investors in many ways :

a) It enables the investors to utilise their surplus funds gainfully.

b) It helps them to shift form one business to another.

c) Stock market quotations enable the investors to know the worth of securities.

d) Stock exchange lessens the risks of the investors by providing a continuous market, high negotiability of securities, correct evaluation, facility to liquidate investment.

11.9 PROCEDURE OF TRANSACTIONS :

A transaction consists of the following four stages :

1. Placing the Order : First of all the client places the order to buy or sell a particular security or both at a fixed price or at the best possible price.

2. Execution of the Order : On receiving the order from the client the broker or his authorised clerk approaches that part of the stock market where the particular security is traded and makes the bargain.

3. Reporting the Deal : After making the bargain, the details of the deal are recorded in the books of the broker and reported to the client.

4. Settlement of Transactions : There are different methods of settlement of transactions depending upon the nature of transaction.

i) In case of ready delivery or cash transaction, payment has to be made immediately on the transfer of securities or with in a minimum period of time.

ii) In case of forward delivery contracts, the settlement is made on a fixed date in future.

iii) In case of transactions on carry over basis, the contract is carried over to next settle ment.

11.10 STOCK EXCHANGES IN INDIA :

There are at present 23 stock exchanges in the country which are recognised by the government under the securities contract (Regulation) Act 1956. Two other exchanges are set up in the reforms era. They are National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI). Among all the stock exchanges, Bombay Stock Exchange is the country's leading exchange in terms of the number of securities listed there.

11.11 NATIONAL STOCK EXCHANGE OF INDIA (NSE) :

National Stock Exchange of India (NSE) was set up in 1993 to encourage stock exchange reforms through system modernisation and competition. It has been set up by financial institutions and banks with IDBI as the nodal agency. It is expected to serve as a model exchange integrating the stock exchanges all over the country by providing nation wide stock trading facilities and electronic clearing and settlements.

11.12 OVER THE COUNTER EXCHANGE OF INDIA (OTCEI) :

Over the Counter Exchange of India (OTCEI), with its headquarter at Mumbai, has started its operations in september 1992. OTCEI like NSE, has been set up with nation wide stock trading facilities, electronic display, clearing and settlement facilities. OTCEI has been jointly promoted by various financial institutions like UTI, IDBI, IFCI, LIC, GIC, SBI Capital Market Ltd., Canbank Financial Services Ltd.

The main objective of OTCEI is to create 'Over-the-counter market in India'. It will help the companies to raise capital market from the market atleast cost and on optimal terms. It will also help the investor to approach the capital market safely and conveniently. It will cater to the needs of the companies which cannot be listed on the official stock exchanges. It will also eliminate the problems of illiquid securities, delayed settlements, unfair prices and so on as faced by the investors.

11.13 STOCK HOLDING CORPORATION OF INDIA LIMITED (SHCIL) :

Stock Holding Corporation of India Limited (SHCIL) was sponsored by seven All India Financial Institutions Such as IDBI, IFCI, ICICI, UTI, LIC, GIC, IRBI. The main objective is to introduce a book entry system for the transfer of shares and other types of securities in placing of existing system.

11.14 CREDIT RATING AGENCIES :

Credit rating agencies rate each company based on its credentials and such rating will help the common investor to take appropriate decisions for investment. At present there are four credit rating agencies in India namely - The Credit Rating Information Services of India Limited (CRISIL), Credit Rating Agency of India Limited (ICRA), Credit Analysis and Research Limited (CARE) and Duff and Phelps (India) Private Limited.

11.15 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI) :

SEBI was set up in 1992 with two objectives ; a) to develop capital market and b) to protect investor's interests. SEBI concentrated on areas such as increasing market transparency, improving the standards of corporate governance, improving market efficiency, reducing transaction costs, enhancing the market safety etc.

11.16 FUNCTIONS :

Under the SEBI Act, SEBI has been assigned the following main functions :

i) Regulating the business in stock exchanges and other securities markets;

ii) Registering and regulating the working of stock brokers, sub brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, portfolio managers, and other interme diaries associated with the securities markets;

iii) Registering and Regulating of collective investment schemes including mutual funds;

iv) Promoting and regulating the working of self regulatory organisations;

v) Prohibiting fradulent and unfair trade practices relating to securities markets;

vi) Promoting investor's education and training of intermediaries of securities market;

vii) Prohibiting insider's trading in securities; and

viii) Regulating substantial acquisition of shares and takeover of companies.

SEBI Regulations : During 1995-96 SEBI introduced a number of rules and regulations which have improved market practice. These rules and regulations notified under the SEBI Act were as follows :

i) Rules on Procedure for Holding Enquiry and Imposing Penalities by Adjudicating Officer.

ii) Rules on Securities Appellate Tribunal (Procedure).

iii) Regulation on Prohibition of Fradulent and Unfair Trade Practices relating to Securities Markets.

iv) Regulation on Payment of Fee (Amendment).

These regulations prohibit manipulation of prices in the stock market, making misleading statements to induce sale and purchase of securities and unfair trade practices relating to securities. Thus these regulations would promote the orderly working of the securities market.

11.17 CAPITAL MARKET REFORMS :

With a view to introduce improved practices and greater transperancy in the capital market, SEBI and the Government have initiated the process of capital market reform since 1991-92. Important capital market reforms are :

1. Controller of Capital Issues was abolished. Now the companies can approach the capital market after clearance by SEBI.

2. SEBI was armed with necessary authority and powers for regulation and reforms of the capital market.

3. Under the securities contract (Regulation) Act 1956, the power to regulate stock ex change was delegated to SEBI.

4. Redressal of complaints of investors should be encouraged by sharing with the recognised associations of the investors.

5. Investment norms of Non-Resident Indians (NRIs) have been liberlised so that they and overseas corporate bodies can buy shares and debentures with the permission of RBI.

6. Indian companies have been permitted to raise capital for modernisation and import requirements in the international capital market through Euro-equity issues.

7. Foreign Institutional Investors (FIIS) have been allowed access to Indian Capital Markets on registration with SEBI.

8. SEBI's autonomy has been reinforced by allowing it to issue regulations and file suits with out prior approval of the government.

9. National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI) started functioning with nationwide stock trading and electronic display, clearing and settlement facilities.

11.18 PRIMARY MARKET REFORMS 1991-92 :

Important primary market reforms undertaken since 1991-92 are summarised below :

i) Merchant banking has been brought under SEBI regulatory framework and they are now required to abide by a code of conduct.

ii) The 'Banker to the Issue has been brought under preview of SEBI for investor protection'.

iii) SEBI has prescribed improved disclosure standards, introduction of prudential norms and simplication of issuing procedures.

iv) Stock exchanges are required to ensure that companies concerned have a valid acknowledgment card issued by SEBI.

v) Companies are required to disclose all material facts and specific risk factors associ ated with their projects while making public issues.

vi) To discourage the use of stock-invest by institutional investors, the facility has been restricted to mutual funds and individual investors.

vii) SEBI has introduced a code of advertisement for public issues for ensuring fair and truthful disclosure.

viii) To reduce the cost of issue, underwriting by issuer has been made optional.

ix) The guidelines for bonus shares have been relaxed.

x) The details of prospectus will be scrutinised by SEBI before the issue of acknowledg ment card.

11.19 SECONDARY MARKET REFORMS SINCE 1991-92 :

i) According to the guidelines of SEBI, the governing body of stock exchanges should have five elected members, not more than four members nominated by the government or SEBI, and three or four members nominated as public representatives, besides its Ex ecutive Director.

ii) SEBI has also introduced capital adequacy norms for brokers and made rules for making the client broker relationship more transparent.

iii) SEBI has introduced regulations governing substantial acquisition of shares take overs.

iv) Private mutual funds have been permitted and many have already been set up.

v) UTI has been brought under the regulatory jurisdiction of SEBI.

vi) Stock exchanges are allowed to introduce carry forward system only with the prior permission of SEBI.

vii) The National Securities Depository Limited (NSDL) has been set up and has started operation in October 1996.

11.20 DIFFERENCES BETWEEN MONEY MARKET AND CAPITAL MARKET :

Money Market	Capital Market
i) It is a market for short term funds for period not exceeding one year.	i) It is a market for long term funds.
ii) It supplies funds for working capital requirements of industries and short-period requirement of Government and for financing current business operations.	ii) It provides funds for fixed capital needs of trade and commerce as well as longterm requirement of Government.
iii) The instruments are bill of exchange, treasury bills, commercial paper, certificates of deposits.	iii) It deals with shares, bonds, debentures and Government Securities.
iv) The instruments are of high value, ATB is of minimum Rs. one lakh. Each CD or CP is for Rs. 25 lakhs.	iv) Shares may be of Rs. 10 Debenture value may be Rs.100/-.
v) The Central Bank and commercial banks are major institutions.	v) Development banks and commercial banks are the major institutions.
vi) Money market instruments do not generally have secondary markets.	vi) Capital market instruments have secondary market-stock exchanges.
vii) There is no formal place. Transactions are done over phone.	vii) Primary issues are placed in the market through brokers. Secondary market is a fixed place.
viii) Reserve Bank of India regulates the market.	viii) SEBI regulates the institutions and procedures.

11.21 FINANCIAL SERVICES :

Financial system in India has been undergoing a rapid transformation due to economic reforms introduced in the early nineties. The efficiency of the financial system is determined by the quality and range of financial services offered. Financial Service Sector emerged as a natural supplement of sophisticated and matured financial system all over the world. As far as the Indian markets are concerned, the financial services sector holds tremendous future in view of the changes in the economy taking place both at the domestic and at the global.

Meaning of Financial Services : In general all types of activities which are of financial nature may be regarded as ‘financial services’.

Earlier banks were not meant for providing non-banking financial services such as leasing, hirepurchase, house finance and so on. Banking Regulation Act was amended in 1983 to permit banks to provide these services either through their own departments or divisions or through their subsidiaries exclusively set up for this purpose.

The financial service is also called financial intermediation. Financial intermediation is the process by which funds are mobilised from savers and make them available to the corporate customers for investment.

Financial services cover a wide range of activities. They can be broadly classified into :
i) Traditional activities and ii) Modern activities.

Traditional activities include :
i) Fund Based Activities
ii) Non-fund Based Activities.

i) Fund Based Activities : which the financial intermediaries render are :

a) Dealing in shares, bonds, debentures of new issues.
b) Dealing in secondary market activities.
c) Dealing in money market instruments.
d) Involving in hire-purchase, leasing, venture capital, seed capital etc.
e) Dealing in foreign exchange market activities.

ii) Non-Fund Based Activities : Non-fund Based Activities are fee based activities. These are not connected with provision of finance. The financial intermediaries are expected to render services.

They are :

a) Managing capital issues.
b) Arranging placement of capital and debt instruments with investment institutions.
c) Arrangement of project finance and working capital funds from financial institutions.
d) Assisting in the process of getting all clearences from the Government departments.

11.22 RECENT TRENDS IN FINANCIAL SERVICES :

Besides the traditional services, the financial intermediaries render a good number of services in recent times. There are new financial products and services. As a result of financial innovations, new products and services are emerging in the capital market. The capital and money markets are widened and deepened.

- Merchant Banking
- Loan syndication
- Leasing
- Hire purchase
- Mutual Funds
- Factoring
- Forfeiting
- Venture Capital
- Securitisation
- Custodian and corporate advisory services.

Financial intermediaries including banks have been expanding their activities in the financial service sector by offering a variety of new products. Some public sector banks in India started subsidiaries to provide financial services - SBI Capital Market, Andhra Bank Financial Services, Canbank Financial Services, Mutual Funds of some public sector banks, LIC, and GIC etc.

The Prominent Financial Services are :

11.23 MERCHANT BANKING :

Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The job of merchant banker is to transfer capital from those who own it to those who need it. The merchant banker now acts as an institution which understands the requirements of the entrepreneur promoters on the one hand and financial institutions, bank, stock exchanges and money market on the other. The services of a merchant banker can be summaries as follows :

1. A merchant banker helps an entrepreneur in conception of idea, identification of projects, preparation of feasibility reports, fixing locations, obtaining money sanctions from State and Central Government departments.

2. Merchant bankers act as sponsor of issues rather than sources of finance.

3. Merchant bankers undertake preparation of project files, loan applications for financial assistance on behalf of promoters from different financial for meeting long term and working capital requirements.

4. Merchant bankers keep register of share holders and debenture holders of their client companies and act as paying agents for the dividends, debentures interest.

5. Merchant bankers render advices on Investment decision, taxation and inflation. They also undertake the functions of buying and selling of securities.

6. Merchant bankers help companies to raise finance by way of fixed deposits from the public.

7. Other activities are :

   i) Corporate counselling for financial institution.
   ii) Services to NRIs for suitable investment opportunity in India.
   iii) Assistance in negotiations of foreign collaboration
   iv) Arranging technology, finance and risk / venture capital.

Merchant Banking in India :

Some public sector banks in India started subsidiaries to provide merchant banking services - SBI Capital Market, Andhra Bank Financial Services, Canbank Financial Services Ltd, Bank of Baroda Fiscal Services Ltd. Most of the foreign banks are offering merchant banking activities. All India financial institutions such as ICICI, IFC, IDBI have also entered this field. Private consultancy firms, technical consultancy organisations, professional merchant banking houses are slowly coming up in India.

Regulation of Merchant Banking in India :

In India the merchant banking activity is governed by :

i) Guide lines given by the Securities and Exchange Board of India (SEBI) and the Ministry of Finance.

Its principal business is to conduct hire purchase transactions. The leasing and hire purchase financing systems are widely in country such as U.K, and U.S. In India, hire purchase credit is given by commercial banks, hire purchase finance companies, State financial corporations and by a large number of sellers of equipment.

ii)Companies Act 1956

iii) Securities Contracts (Regulation) Act, 1956

iv) Listing guidelines of stock exchange.

The registration of merchant banking with SEBI is compulsory for the activities such as :

a) Debenture trusteeship
b) Authorization
c) Portfolio management
d) Capital issues pre and post
e) Take over by acquisition of shares.

11.24 LOAN SYNDICATION :

This is more or less similar to consortium financing. But, this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

11.25 LEASING :

Leasing has become a growing business activity in India. It has become a major source of financing the projects of commercial and industrial equipments. Leasing may be defined as “a method of acquiring right to use an equipment or asset for consideration”.

The party offering the asset for lease is called lessor and the party receiving the possession of the asset for lease is called lessee. The agreement between the lesser and the lessee is called lease agreement. The company offering such a service is called a leasing company. Leasing facility provides an opportunity to use the asset with out owning it. The lessee pays lease rent for using the asset during the lease period. On the expiry of the lease period the lessee returns the asset to the lesser unless he choose to renew the lease contract. NBFCs offer leasing facilities.

11.26 HIRE PURCHASE :

Hire purchase is a method of selling goods. Hire purchase refers to the arrangement wherein the buyer pays some advance and take possession of the asset from the seller with an understanding that the balance amount along with interest will be paid to the seller over an agreed period in equal installments. The buyer becomes the owner of the asset only when he clears the last instalment. In case he fails to pay even one instalment, the seller has the right to take back the possession of the asset and treat the instalments paid earlier as hire charges for use of the asset. The company offering such service is called hire purchase finance company.

11.27 MUTUAL FUNDS :

Mutual funds are investment institution. They mobilise resources from savers and invest them in equities, bonds, government securities, money market instruments etc, and thus build up diversified port folio. Investment planning is carried on by professional fund managers. The fund managers act as portfolio managers for a large number of investors. Investment in mutual fund products thus represent indirect investment in shares and bonds of several companies to minimise risks and maximise returns.

Individual investors buy units of mutual funds. Each unit represents a share in the assets of a scheme. The individual investors become unit holders just like shareholders. Mutual funds float schemes with different styles to satisfy the varying needs of investors.

11.28 FACTORING :

Factoring is an arrangement to purchase the book debt of a company or firm. It is a relationship between financial institution (called factor) and a business concern (supplier) that sells / provide goods or services to its customers. The factor purchases book debt either with or without recourse to the supplier. He also controls the credit extended to the customers and administers the sales ledger of the supplier. On purchasing the book debts / bills receivables for discount, the factor pays the trader the balance in cash. The factor collects them at the end of the maturity. The trader finds this arrangement very convenient as his funds are not blocked in bills receivables or book debts and flow of funds is ensured to take care of working capital requirement collecting receivables is called debt factoring and managing payable is called credit factoring. There are NBFCs which have specialised skills to take care of debt factoring or credit factoring or both.

11.29 FORFEITING :

Forfeiting is the conversion of foreign credit bills into cash by discounting them at a fixed rate. It applies to international trade only. The discount rate is decided on the risks or debtor country, currency risk, marine risk and so on. Forfeiting service is provided through EXIM Bank or in collaboration with foreign forfeiting agency has to bear the risk. Forfeiting provides alternative source of finance mainly for exporters.

11.30 VENTURE CAPITAL :

The start up companies and individual entrepreneurs rely greatly on venture capital to raise the seed capital to start their business activity. NBFCs provide venture capital to the needy. They fill up the gaps in the conventional financial mechanism where in it is very difficult for a fresher to obtain loans from the traditional banks for his new risky venture. Venture capital funding focuses on new entrepreneurs, commercialisation of new technologies, and the service sectors. The success of venture capital funding organisation lies in selection of the investment. Venture capital is available for new projects, projects relating to expansion, modernisation, diversification.

11.31 BILLS DISCOUNTING :

Discounting of bills constitute main source of profits for every financial institution. When the banker provides ready money against an endorsed bill to the customer before the date of maturity by charging some commission (which is called discount), the bill is said to be dis counted. As a measure of giving fillip to commercial bill market, RBI permitted banks to rediscount bills among themselves and with other eligible financial institutions and financial companies.

11.32 NON-BANKING FINANCE COMPANIES :

Financial Intermediaries are those institutions which link lenders and borrowers. The process of transferring savings from savers to investors, is known as financial intermediation. Commercial banks and co-operative credit societies are called banking finance intermediaries. Non-banking financial companies (NBFCs) are the professional version of indigeneous money lenders. NBFCs have emerged as an important financial intermediary due to simplified sanction procedures, attractive rate of return on deposits, flexibility and speed of service in meeting the credit needs of the customers.

Meaning of NBFC :

A non-banking financial company means :

a) a financial institution which is a company.

b) a non-banking institution which is a company and which has its principal-business - the receiving of deposits, under any scheme or lending in any manner.

The principal business of non-banking financial company is that of receiving deposits in any form or under any scheme and advance loans, invest in securities, provide hire-purchase finance or equipment leasing. The companies will come under NBFCs as per the definition of Non-Banking Financial Companies Directions, 1977 include Hirepurchase, Finance companies, Equipment leasing companies, Loan companies, Investment companies. The other non-banking financial entities regulated by RBI include Mutual Benefit Financial Company (MBFCs) i.e. nidhi company, and Miscellaneous Non- Banking Company (MNBC) namely, chit fund company.

Functions of NBFCs : The functions performed by NBFCs may be described as under :

1.They are able to attract deposits of huge amounts by offering attractive rates of interest and other incentives. Half of the deposits are below 2 years time period.

2. They provide loans to whole sale and retail merchants, small industries, self employment schemes.

3. They provide loans with out security also. Hence they are able to charge 24 to 36 percent interest rate.

4. They run chit funds, discount hundies, provide hirepurchase, leasing finance, merchant banking activities.

GROWTH OF NBFCs :

By the end of march 2001, there are 1005 NBFCs reported to RBI with total assets of Rs. 53,878 crores and aggregate public deposits of Rs. 18,085 crore. Over the last three decades, there have been significant development in the functioning of NBFCs. The development was substantial especially in the case of hire purchase and leasing companies.

The following are the important reasons for the rapid growth of NBFCs :

i) the ability to attract house hold savings.
ii) relatively low degree of regulation when compared to banks.
iii) a high level of customer - orientation through customised and cost- effective services.
iv) less formalities with regard to sanction requirements.
v) higher returns offered by NBFCs to depositors when compared to banks.
vi) funding the sectors, such as vendors in the unorganised sector that are ignored by the commercial banks.

CONTROL OVER NBFCs :

The RBI Act was amended in 1997 providing for a comprehensive regulatory frame work for NBFCs. The Act provides for compulsory registration of NBFCs irrespective of holding of public deposits.

1. Every NBFC must register with RBI to commence and carry on business.
2. At the entry point they have a minimum net owned funds of Rs. 2 crore.
3. Guidelines regarding capital adequacy, income recognition, provisionising, asset classi fication issued by RBI are to be followed.
4. Registered NBFCs must transfer every year 20 percent of post tax profits to the Reserve Fund.
5. They have to create reserves for bad and doubtful debts.
6. Reserve Bank is empowered to issue directives relating to proportion of amounts to be invested in approved securities.

Non-banking financial companies are now called financial companies as per the Financial companies Regulation (FCR) Act 2000. This Act was enacted by Government of India to protect the interest of depositors and regulate the financial institutions more effectively.

11.33 SUMMARY :

Capital market in India is an important source of funds for public as well as private sector undertakings. To promote the capital market and protect investor interests, SEBI has announced in the recent years several reforms particularly in the areas of structure and functioning of stock exchanges, automation trading and post trading system.

11.34 SELF ASSESSMENT QUESTIONS :

Short Answer Questions :

1. Describe the constituent of Indian Capital Market.
2. Distinguish between money market and capital market.
3. What are Stock Exchanges ? What are their functions ?
4. What are credit rating agencies ?
5. State the functions of Securities Exchange Board of India.
6. What are the financial services?
7. What is meant by merchant banking ?
8. What is factoring?
9. What are mutual funds ?
10. What is leasing ?

11. What is venture capital ?

12. What is Hire Purchase?

13. What are the functions of NBFC?

Long Answer Questions :

1. What is capital market ? What is its importance and functions ?
2. Explain the role of SEBI in regulating capital market.
3. What are the constituents of Indian capital market ? Discuss the reforms relating to Indian Capital market.
4. Review the measures implemented by the Government to regulate secondary market.
5. Explain the role of merchant banks in providing financial services.
6. Elucidate the recent trends in financial services.
7. Discuss the role of NBFCs in the Indian capital market.

11.35 Reference Books / Suggested Readings.

1. Banking and Financial Systems	-	A.V.Ranganadha Chary, R.R.Paul.
2. Banking and Financial Systems	-	Mithani & Gordon
3. Banking and Financial Systems	-	A.R.Aryasri, V.V.Ramana Murthy.

- P. USHA RANI

LESSON - 12

BANKER AND CUSTOMER

12.0 OBJECTIVE

After studing this lesson you should be able to understand the following :

(1) Relationship between Banker and Customer.

(2) Rights and Duties of banker and customer.

STRUCTURE OF LESSON

12.1 Introduction
12.2 Definition of a banker
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12.1 INTRODUCTION:

The Banking Regulation Act of 1949 defines banking and describes the functions of banks. The customers of banks are either depositors or borrowers or both. Banks act as intermediaries between savers (depositors) and investors (borrowers). Hence we have to define 'Banker' and 'Customer' and discuss the law relating to the general and speical relationship between them.

12.2. DEFINITION OF BANKER :

Dr.H.L.Hart defines a banker as one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on 'Current Account'. Hart has covered only few functions of banks i.e. accepting deposits of money and paying money by honouring cheques. He has not covered the lending business of bank.

According to Sir John Paget, a person, to be called a banker, should perform four functions : (1) take deposit accounts (2) take current accounts (3) issue and pay says that even if all the four conditions are satisfied, on claiming to be banker must satisfy four other important conditions. They are :

(i) The banking business must be a part of his occupation.

(ii) The banking business must not be a subsidiary one.

(iii) He must profess to be a banker and public must accept him as such.

(iv) He must have the intention to get profit by so doing.

12.3 DEFINITION OF BANKING REGULATION ACT :

The Banking Regulation Act, 1949 defines the term banking as ' the accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.

12.4. DEFINITION OF CUSTOMER :

Sir John Paget's Definition :

Sir John Paget expressed two conditions to be satisfied by a person, who constitutes a customer of a bank. (1) There should be some recognizable course or habit of dealing between him and the bank and (2) those dealings must be in the nature of regular banking business.This is the other view.

12.5. RELATIONSHIP BETWEEN BANKER AND CUSTOMER :

The Banker-Customer relationship commences as soon as an account is opened at a bank.

A. General Relationship between a Banker and Customer : There are three types of general relationships between the banker and customer. There are :

1. Debtor and Creditor Relationship.

2. Trustee and Beneficiary Relationship and

3. Agents and Principle Relationship.

Debtor Creditor Relations :

In the words of Sir John Paget, the relation of banker and customer is primarily that of debtor and creditor, 'the respective positions being determined by the existing state of the banker in a fiduciary capacity, but is replaced by a debt due from the banker.

12.6.GENERAL FEATURES OF DEBTOR AND CREDITOR RELATIONSHIP

There are some general features to the relationship between banker and the customer as debtor and creditor. There are :

(a) Demand for Payment Necessary : The debt due from the banker is different from ordinary commercial debt. In the case of commercial debt the creditor demands for its repayment and the debtor may repay on his own accord.

(b) Proper Place of Demand for Payment Where the Account is kept : A Commercial bank may have branches at many places, yet it is considered as a single unit. However, the customer opens an account in his name in a particular branch.

(c) Proper Time to Demand : The customer can demand repayment only during the business hours of the bank.

(d) Proper Manner to Demand : According to Sec. 5(b) definition of the banker, deposits are withdrawable by cheques, drafts, order or otherwise. It cannot be oral demand.

(e) The Demand may be a Part of the Debt : Generally customers withdraw money from bank as only part of their deposits depending upon the necessity.

(f) Banker and the Law of Limitation : In the case of ordinary or general debt the limitation of debt begins form the date of lending but for the banker's deposit, the limitations (3 years) begins from the date of demand by the depositor and not from the date of deposit.

Trustee and Beneficiary Relationship :

Banker also acts as a trustee when customers deposit valuables and securities for safe keeping. In the event of liquidation, the valuables and securities lodged with him are not available for distribution among creditors.

Agent and Principal Relationship :

Now-a-days, banks perform many functions as agents of customers. When a banker collects cheques, bills, dividends, interest on behalf of his customers, he acts as agent of customer. When a banker sells securities and makes payments such as taxes and other premium, he acts as the agent of the customer.

12.7 SPECIAL FEATURES OF THE RELATIONSHIP BETWEEN BANKER AND CUSTOMER :

1. Statutory Obligation to Honour Cheques : The banker opens a current account of a customer and undertakes to honour the drawn by his customer, so long as there is sufficient balance in his
account.

The Negotiable Instruments Act, 1881 imposes the same duty on a banker. Section 31 lays down three conditions for the banker's obligation to pay cheques.

(a) There must be sufficient funds of the drawer in the hands of the drawee.

(b) The funds must be properly applicable to the payment of a cheque.

(c) The banker must be duly required to pay.

2. Right of General Lien : The second feature is Banker's General Lien. Under this the banker can retain goods and securities bailed to them, as a security for a general balance of accounts. This bailed to them, as a security for a general balance of accounts.

3. Banker's Obligation to Maintain Secrecy of the Accounts : This obligation was recognized in Tournier case. The banker should not disclose the state of his customer's account, as it affects adversely his business and credit.

4. To Charge Compound Interest : The banker is entitled to charge interest for every half-year. This is the common practice. In the absence of any agreement to the contrary, a tanker can charge compound interest.

5. Claim Charges on Unremunerative Accounts : A banker can claim incidental charges. Every customer is expected to keep a remunerative credit balance in his account. Otherwise, he will be required to pay some amount. This varies from 1/8 to 1/4th % on the turnover in England and Rs. 1/- to Rs. 3/- in India.

6. Limitations and Deposits : The ordinary rule that a debt will be time-barred after three years, does not apply to deposits. This was decided in *Joachimson vs. The Swiss Banking Corporation.*

7. Banker has a Right to Set-off : Right to set-off is nothing but mutual claims of the debtor and creditor are adjusted together and the remaining balance is paid. The right to set-off is a statutory right of the banker.

8. Right of Appropriation of Payments : When a debtor owes two or more different debts to the creditor any payment made (which is not sufficient to meet any debt) can be appropriated and credited to one account of his choice.

9. Banker's Obligation to Honour Cheque : By opening a current account in the name of a customer the bank undertakes to honour the cheques drawn by a customer so long as the latter's balance is sufficient to allow him to do so. The cheques must be in proper form and are presented in a reasonable time after the ostensible date of their issue.

The obligation of the banker to honour the cheques of the customer is a statutory obligation. Section 31 of the Negotiable Instruments Act reads of follows :

The drawee of cheque, having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque when duly authorised so to do and in default of such payment must compensate the drawer for any loss or damage caused by such default.

As stated already, this obligation may be extended by an agreement, express or implied, to the amount of overdraft agreed upon.

12.8 CONSEQUENCES OF WRONGFUL DISHONOUR :

If a banker wrongly dishonours a cheque, he becomes liable to compensate the customer for any loss or damage caused to the customer by such dishonour. (*Marzetti v. Williams)*. The words 'loss or damage' do not merely refer to the pecuniary loss that a customer may suffer; it also includes the loss of credit or business reputation.

The rule will apply even if the cheque was dishonoured through inadvertence. In one case where the cheque was dishonoured through inadvertence and in fact was subsequently paid, the damages were heavy, because the discredit any injury to the person whose cheque was refused was of a serious nature. (*Reiin v. Steward*)

12.9 WHEN CAN A BANKER DISHONOUR CHEQUES :

Banker is liable to pay damages if he dishonour cheque without reason or justification. However, there are some reasonable and justifiable grounds to the banker to dishonour cheques. They are :

1. Countermanding of Payment : When the Banker receives notice from the customer to stop payment, this is called countermanding of payment by the customer. This must be done by the drawer in writing.

2. Defect in the Title of the Person Presenting : When the banker has knowledge of any defect in title of the person presenting the cheque, he should not pay it.

3. Notice of Customer's Death : When the banker gets intimation about the death of his customer, he should stop payments of Cheques issued by him. However he can honour cheques, if he is not aware of the customer's death.

4. Insolvency of a Customer or Winding up of a Company : When the Banker receives notice of the presentation of the Insolvency petition against the customer, he should not honour cheques. The date of the receiving order passed is important for the Banker.

5. Insanity of a Customer : When the customer becomes insane or of unsound mind the banker should refuse payment of his cheques.

6. Garnishee or other Order : When the Banker receives a Garnishee injuction or other attaching the Customer's money in his account, he should not honour cheques drawn subsequently. Such an order restrains the customer from operating on the account.

7. Notice of Assignment of Credit Balance : The Banker should not honour cheques. When he receives notice of assignment by his customer of available credit balance.

8. Knowledge of Breach of Trust : When the banker has knowledge that the customer intends to use the funds in a trust account in breach of trust, the banker is justified in not paying cheques.

9. Duty to Maintain Secrecy of Customer's Account : Another special feature of the relationship between the banker and customer is that the banker should not, except on reasonable and proper occasions, disclose matters relating to the customer's account.

12.10 Rights of a Banker

Closing of Account by the Customer : A customer can close his account in a bank for any one of the following reasons.

1. When he no longer in need of the account.
2. When he is dissatisfied with the services of banker.
3. When he can get a higher interest in other banks.
4. When he lost confidence in the solvency of bank.

1. Right of Lien : The right of the creditors to retain the goods belonging to the debtor until the amount due is paid to the former is called lien. For instance suppose B owes Rs. 1000 to A.

A particular lien is attached to some specified goods. It is the right to retain the possession of those goods in connection with which the debt arose. The following are the differences between general lien and particular lien.

General Lien	Particular Lien
1. The creditor can retain the goods/ property for non-payment of any debt due to him.	1. The creditor can retain goods/property of the debtor only for non-payment of particular debt.
2. The line is available only to few persons like lawyers, factors etc.	2. It can be exercised by any person who has special time, labour and money on goods and securities give to him.

2. Banker's Right to Set-off (Combining Accounts) : Set off may aptly described as the right of a Banker to appropriate the credit balances in one accounts in one account of the customer towards sum due by him to the customer in another account in order to arrive at the net sum due.

12.11 CLAYTON'S CASE :

There was a partnership firm doing banking business by name Devayens, Davies Noble & Co which had five partners-Devayens, Daws, Noble, Gaft and Barwock. Mr. N. Clayton was the chief creditor of the firm who was having a current account. After some time Devayen, a partner died and the surviving partners continued the business under the old name of the firm, inspite of objections made by the executors of the deceased partner. About an year after, the firm became insolvent.

At the time of Devaynes death, Clayton's account showed a credit balance of 1713. He continued to operate the account. Between the death of the partner and failure of the firm, Clayton withdrew more than 1713 but also paid more than 1713. When the firm became insolvent, Clayton claimed the money form the estate of the deceased partner. His claim was that (a) the amount existed in his account at the time of death of the partner and the amount existed at the time of insolvency of the firm was the same. Hence the deceased partner's estate is also liable to pay him. (b) He withdrew the amount after the death of partner. (c) At the time of the death of the partner, the firm is solvent. All the partners are jointly responsible for discharged debts. The legal heirs of the deceased partner are also responsible.

These arguments were rejected by the court. Clayton's claim was rejected. Sir Willion Grant MR. the judge, observed that is the case of a running or current account, provided there is no specific appropriation by the debtor or creditor, the presumption is that the sum first paid was first drawn out and the first item on the debit side is reduced by the first item on the credit side.

Hence deceased partner's estate was not liable. Hence the conditions of application of Clayton's rule are: (i) the account should still be running and (ii) there should be no agreement to the contrary between the debtor and creditor.

The rule in Clayton's case of great significance to bankers since they have running accounts with their customers. Suppose X has stood surety for an overdraft granted to Y for Rs. 5000. Suppose the balance owing to the bank on a particular date is Rs. 5,000 and on that date X gives notice of termination of the contract of guarantee. Suppose further, that the banker has not closed the account and that X subsequently paid in Rs. 5,000 and then withdrew Rs. 5,000. When X paid in Rs. 5,000, it will be taken as the payments of the sum due on the date of termination of the contract of guarantee. The sum subsequently drawn out is considered a fresh advance to which the contract of guarantee furnished by X does not apply.

So, the banker must close the account as soon as he receives notice of termination of the guarantee and open a fresh account for subsequent transactions. Then he can hold the surety liable for the sum due to him on the date of such termination. Otherwise he still lose his rights against the surety on account of the operation of the rule in Clayton's case.

The rule in Clayton's case also applies to the guarantee given by the bank. However, if the debtor appropriates the payments in a particular way, the rule in Clayton's case is overruled. Further when a second mortgage is effected in respect of property mortgage is effected in respect of property mortgaged in favour of the bank, the bank must close the first the account and open a fresh one, so that the property remains as security for the bank's overdraft at the time of the second mortgage.

12.12 GUARANISHEE ORDER :

When a creditor who has lent money fails to recover the money, he may file a suit against the debtor and obtain a decree from the court for payment of the debt. Sometimes, the creditor may not find any property in the possession or debtor for execution of decree. Yet, there may be some person who is in possession of debtors the debtor's property in the hands of the third party. If the court issues such order, such order is called 'Garnishee order'.

Garnishee Order is an order of the court. It is issued under order 21, Rule 46 of the code of civil procedure, 1908, in case of debtor's failure to pay his debt. Such order attaches the funds in the hands of a third party belonging to the debtor. If the debtor has money in the bank, the creditor may request the court to attach the funds of the debtor in the hands of the banker. Such an order issued by the court is called "Garnished order". In other words, garnishee order is a judicial order served on a bank to suspend its dealings with a customer. The creditor on whose request such an order is issued is called the "judgment creditor". The debtor against whom the order is issued is called the "judgment debtor". The third party (banker) on whom the order is served is known as "garnishee".

Procedure for issuance of Garnishee order : The Garnishee order is issued by the court in two parts : (1) Order NISI (2) Order Absolute.

(1) Order NISI : It is a preliminary order served by the court on the bank. This order operates as freezing the debt. By this order the court :

a) asks the banker to freeze the debtor's account.

b) asks the banker to explain why the funds in the account so freezed should not be used for payment of Judgement creditor.

The grounds may be overdraft of the account, assignment of the account, the banker's lien or set-off on the account etc.,

(2) Order Absolute : This is an order of the court requiring the bank to pay into the court a specified sum of money out of the customer's account to meet the creditor's claim.

Effects of Garnishee order : As soon as the "Order NISI" is issued on the bank, the dealings on account of the judgement debtor are to be stopped. The cheques drawn by the customer subsequent to the service of order NISI are to be refused payment.

Amount not covered by the Garnishee Order : The garnishee order attaches only that balance which is lying in the customer's account at the time when the order is served on the banker. In other words, it attaches the actual balance of the account as on that date.

Non-Compliance of Garnishee Order : Garnishee order is not binding under the following circumstances :

1) When the judgement debtor's identity, as quoted in the order, is vague.

2) When the judgement debtor's account at the bank is overdrawn.

3) If the judgement debtor's account is previously assigned to a third party, and the banker has a due notice of it.

4) If the banker is entitled to set-off for a debt due to him from the judgement debtor.

5) When the credit balance of the judgement debtor is held in "trust", and the banker is aware of that position.

6) Joint accounts are not attachable for the individual debts of on e of the parties to the account. Joint account can be attached only when all the Joint account holders are Joint Judgement debtors.

7) Deposits made by the customer after the garnishee order is issued are not attachable.

8) The personal account of a partner can be attached for payment of a firm's debt. But the firm's account cannot be attached for the payment of a personal loan of a partner.

9) Uncleared cheques are not attachable.

10) Any deposit paid in to the bank by the customer for meeting a specified obligation or to pay specific cheques are not attachable.

Steps to be taken by Bank on receipt of Garnishee Order :

1) As soon as the order NISI is issued, the banker should inform the customer that his cheques will not be honoured as long as the order stands.

2) If the garnisher order is issued for a limited amount, the banker may transfer that much of amount to a suspense account pending payment into the court. The customer's account may be permitted to be operated with the balance.

3) If the garnishee order is issued for the attachment of the whole funds of the judgement debtor's account with the bank, the bank should not make payment out of the account so freezed. The account is to be suspended. A bank should never disregard legal process.

4) Garnishee order has no prospective operation. Money paid into the account by the customer after the service of the garnishee order are not attachable by such order. So when the order is received, the banker may open a new account of his customer for money paid in by him. The customer can withdraw from such a new account.

5) The banker should not apply the credit balance of the judgement debtor's account to wards contingent liabilities of the customer.

6) When order NISI is made absolute and the court directs the banker to pay money, the banker has to pay the amount as per the court's direction.

7) The garnishee order does not apply to cheques, drafts, bills etc., deposited with the banker for collection but not yet collected. So the banker should not add such collections to the credit balance attached to the order.

8) When the judgement debtor's account is overdrawn as on the date of service of the Garnishee order, the banker is in no way affected by the order.

12.13 SELF ASSESSMENT QUESTIONS :

Five marks Questions :

Define the following :

1. Banker
2. Customer
3. Bankers Lien
4. Set-off
5. Banker as a trustee
6. Banker as a debtor of,
7. Banker as an agent.

Ten marks questions :

1. What do you understand by the term banker ?
2. Explain banker as a trustee
3. What is debtor-creditor relationship between banker and customer ?
4. State Clayton's case.
5. What is bankers lien ?
6. What are the special features of relationship between banker and customer ?

Twenty marks questions :

1. Define banker and customer. Explain general and special features of relationship between banker and customer.

2.What is banker's lien ? When can he exercises such a lien ?

3. When can a banker dishonour a cheque ? What are the consequences of wrongful dishonour of cheque ?

4. State and explain the banker's obligation to honour cheques. What risk he has to face in the case of wrongful dishonour of a cheque ?

12.14 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin's Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

SRI. V.VIJAY KUMAR

LESSON - 13

SPECIAL ACCOUNTS

13.0 OBJECTIVE :

After studying this lesson you should be able to understand the following :

1. Different types of customer's accounts.
2. Rights and duties of banker towards this special types of customer's.

STRUCTURE OF LESSON

13.1 Introduction
13.2 Minors
13.3 Lunatics
13.4 Drunkards
13.5 Married Women
13.6 Joint Accounts
13.7 Partnerships
13.8 Joint Stock Companies
13.9 Executors and Administrators
13.10 Trustees
13.11 Joint Hindu Family Firms
13.12 Educational Institutions, Charitable Associations, Clubs etc.
13.13 Deposit Accounts
13.14 Pass Book
13.15 Fixed Deposits
13.16 Dormant Accounts
13.17 Self Assessment Questions
13.18 Reference Books

13.1 INTRODUCTION :

The usual customer of banks are majors (exceeding 18 years) who have credit worthiness. For opening of an account with the bank, either a saving or current account, the person must be capable of depositing the prescribed minimum.

1. Minors
2. Lunatics
3. Drunkards
4. Married Women
5. Joint Accounts
6. Partnerships
7. Joint Stock Companies.
8. Executors and Administrators.
9. Trustees.
10. Joint Hindu Family Firms.
11. Educational Institutions, Charitable Association, Clubs etc.

13.2 MINORS :

According to Indian Law, a person is a minor until he completes his 18th year. If he is under the guardianship of Court of Wards, he continues to be a minor until he completes his 21st year.

Precaution : The Banker should take the following precautions before opening an account in the name of minor.

The banker runs no risk in dealing with a minor as long his account is in credit. However the fact that a contract with a minor is void, it is advisable to open the account in the name of his guardian.

Minor as Agent : A minor can act as agent of another person competent to contract, provided he is duly authorized. For instance, minor son may take contracts besides endorsing cheques and bills on behalf of his father.

Minor as Partner : There is nothing to prevent a minor from becoming a partner in a firm and transacting business on its behalf.

13.3 LUNATICS :

Under Sec. 12 of the Indian Contract Act, persons of unsound mind are disqualified from entering into contracts.

13.4 DRUNKARDS :

If a person who is a party to a contract can prove that the time of entering into the contract he was incapable, from the effect of liquor.

13.5 MARRIED WOMEN :

According to Indian Contract Act, a married woman is competent to enter into contracts, to acquire and sell property, to lend and borrow money, etc. In another words she has all the rights which a man has.

1. Where the husband has given his consent or authority.

2. Where the debt is incurred for the purchase of necessities of life, in case the husband defaults in providing the same to his life.

13.6 JOINT ACCOUNTS :

When an account is opened in the names of two or more persons, who are not partners in a firm or who are not joint trustees, it is called a joint account. When a joint account is opened the banker should obtain a comprehensive mandate. The mandate should cover all points because the right to draw cheques conferred upon a person does not automatically confer upon him the right to deal in securities, to contract debts, or to deal in bills of exchange. If one of the joint account holders obtains an overdraft, the others do not have liability. So it is necessary that definite instructions should be obtained on the following matters.

13.7 PARTNERSHIPS :

Persons who have entered into partnership agreement are individually called partners. All partners are collectively called a 'firm'.

1. The existence of written or implied agreement to do lawful business.

2. To share profits.

3. Dual role of every partner as principal and agent.

4. Partner's implied authority to bind all other partners by his conduct in the ordinary course of the business.

5. The maximum number of partners is 20 and the minimum number is 2. In the case of banking firms, the maximum number of partners is 10.

Partner's Implied Authority : Partner's implied authority in a firm is a most significant feature. Each partner is the accredited agent of the firm. A transaction entered into by him is binding on the firm if the transaction is related to is normal business.

1. Opening of Account in the name of a firm : The account must always be opened in the name of the firm but not in the name of individual partner or names of partners.

2. Signature by all Partners on the Account Opening Form : Though any one of the partners is entitled to open the account, the banker in his own interest shall ask all the partners to sign on the account opening form.

3. Death of a Partner : When a partner died, the partnership comes to an end. The legal heirs of the deceased partner does not automatically become the partner of the firm. The legal heir has only the right to recover the money due to him from the partnership firm.

4. Bankruptcy of a Partner : The partnership also comes to an end when one of the partners becomes bankrupt. The banker should not honour cheques drawn by the bankrupt partner, unless it bears the signatures of the other partners as well.

5. Insanity of a Partner : A partnership is not dissolved when one of the partners becomes insane, but it becomes as sufficient reason for the dissolution of the firm.

6. Retirement of a Partner : When a partner retires from the partnership firm, he must notify the same to the banker. Otherwise , he also becomes liable for the debts incurred by the firm.

13.8 JOINT STOCK COMPANIES :

1. The banker should examine the certificate of incorporation, Memorandum of Association and Articles of Association of the company, before opening an account.

2. In the case of a public company, he must inspect its certificate of commencement of busi ness and satisfy himself that the company has been authorized to commence business.

3. He should receive a copy of the Board's resolution appointing him as the company's banker stating the mode of operation and naming the person authorized to operate upon the account.

4. He should not be the first directors of the Company.

5. In case of existing companies, he should ask for copies of Annual Accounts and reports for some previous years.

Opening an Overdraft Account : The banker should take the following steps before opening an overdraft account in the name of a registered company.

He should go through the Memorandum and Articles of Association for the borrowing powers and restrictions thereon particularly in a non-trading company. All trading companies have an implied power to borrow to such an extent as is reasonable and necessary for the carrying out of their declared objects.

13.9. EXECUTORS AND ADMINISTRATORS :

Executors and administrators are persons who are appointed to conduct the affairs of a person after his death. When a person known as *'testator'* appoints another person for this purpose through a will, he is known as an Executor. If the will of the testator does not mention the name of the Executor, or if the person appointed as Executor dies or refuses to act, the court appoints a person who is known it as Administrator. Both the executor and administrator perform the same duties, *i.e.* to realise the assets of the deceased and to pay off his debts. The Executor is appointed by the will and the Administrator is appointed by the court through a letter of administration.

13.10 TRUSTEES :

A trust "is the relationship which arises whenever a person called the trustee is compelled in equity to hold property, whether real or personal and whether by legal or equitable title for the benefit of some persons (of whom he may be one and who are termed *cestui ques trust*) or for some object permitted by law, in such a way that the real benefit of the property occurs not to the trustee but to the beneficieries or other objects of the trust."

13.11 JOINT HINDU FAMILY FIRMS :

The Joint Hindu Family Firm is an institution peculiar to our country. The firm is managed by the Karta. When the Karta dies business also desolves on the legal hiers just like any other property.

13.12 EDUCATIONAL INSTITUTIONS, CLUBS AND OTHER ASSOCIATIONS :

These associations may be registered under the Societies Registration Act or the Indian Companies Act. If they are not so registered, the banker should bear in mind certain important matters.

13.13 DEPOSIT ACCOUNTS

Banks mobilize funds in the form of various types of deposits. There are fixed deposits, savings deposits, current accounts etc. Presently new private sector bans and foreign banks are offering several inducements.

1. Demand Deposits or Current Accounts :

Current deposits form the most important type of bank deposit. In the case of these deposits, the banker undertakes to honour his customer's cheques so long as the latter account is in credit.

Advantages to the Customer of Having a Current Account :

Opening of a current account is a source of great convenience to the customer.

(a) As cash, cheques and drafts are deposited in the bank's account, they are perfectly safe.

Methods of Opening the Current Account :

1. Account Opening Form :A prospective customer while requesting the banker to open a current account in his name fills in an *Account Opening Form* Supplied by the banker.

2. Photographs : The applicants has to give two passport size photograph one to be pasted in the pass book and the other on specimen signature sheet.

3. Reference : The customer has to cite the names of one or two references about his standing and the respectability. The banker not only has a personal interview with the prospective customer, but writes to the referees cited and obtains the necessary information regarding the prospective customer.

1. Specimen Signature : Every prospective customer is expected to have read the rules of business of the bank and to confirm in writing his willingness to comply with and be bound by them before his account is opened. He is required to supply his bankers with one or more specimen signatures and these are usually entered in a signature book maintained for the purpose by the bank.

If the banker accepts the application form submitted by the customer, a contract is formed between them, and the person becomes the customer of the bank in the legal sense of the term when the very first transaction takes place between them.

2. Opening of Accounts : After opening the account, the banker hands over to the customer (1) a cheque book, (2) a paying-in-slip book, and (3) a pass book.

3. Cheque Book : The customer has to draw a cheque in order to withdraw money from the bank. The cheque may be in favour of the customer himself or in.

4. Paying-in-slipbook : When the customer wishes to deposit money into his current account, he will have to fill in a form called paying-in-slip form. If cash is deposited the denomination of the notes paid in must be noted in the form.

5. Pass Book : The pass book is a replica of the customer's account in the bank's ledger.The pass book need not be presented along with the cheque for payment. The pass book may be sent periodically to the bank and the bank enters all the transactions it has found in its own books in the pass book.

2. Savings Deposits Accounts :

In order to cater to the needs of people with low incomes and to encourage thrift among such people, post offices in our country started savings accounts.

13.14 PASS BOOK :

The pass book is a small handy book issued by a banker to his customer who has a current or saving account to record all transactions between them. In fact it is an authenticated copy of the customer's account in the books of accounts of the banker.

Features :

The important features of the pass book are :

(i) Entries in the pass book are to be made by the bank staff only. The customer cannot make any entry in the pass book.

(ii) It must be sent by the customer periodically to the banker to up-to-date entries.

(iii) In case of a Saving Account, the pass book must accompany the withdrawal slip, unless there is cheque book facility.

Legal Aspects of Pass Book : Though the pass book is an anthenticated copy of the customer's account with the bank, there is no unanimity of views regarding the entries in the pass book.

13.15 FIXED DEPOSITS :

Banks accept fixed deposits varying for period three months to five years and more. The depositor cannot withdraw the amount of the fixed deposit until after the expiry of the period. The bank allows interest on these fixed deposits. The deposit rate varies, depending upon the period of the deposit.

The depositor has to fill in an application form mentioning the amount of deposit, the period of deposit and the name or names of the persons in whose favour the deposit receipt is to be issued. Banks may fix a minimum amount for a fixed deposit account.

Relationship Between the Banker and the Person having a Fixed Deposit :

We have seen previously that the relationship between a banker and his customer who opens a current account is that of a debtor and a creditor.

Fixed Deposits-Statute of Limitation :

There is no clearcut answer to the question when the statute of limitation commences in the case of fixed deposits either in the Acts or in decided cases. Some contend that it commences from the due date of payment of the fixed deposit.

Fixed Deposit Receipt :

The banker gives a fixed deposit receipt for the amount of the deposit. It is generally marked not transferable. A fixed deposit receipt is not a negotiable instrument. The transferee of such a receipt does not get a better title to it than the transferor himself had.

Collection of the Amount of Fixed Deposit :

On the expiry of the period of the fixed deposit, the depositor may present the fixed deposit receipt at the bank and obtain payment.

Demand Account :

Some banks are now offering Demand Accounts. These accounts are safe and convenient way to manage the share portfolio of the customer with a range of facilities such as demand of securities, transfer of securities, Pledging of securities and freezing and defreezing of securities lying in the account.

Insurance of Bank Deposits :

The failure of Palai Central Bank, a scheduled bank in South India, made the policy makers to think of providing insurance cover to deposit holders. On the model of deposit Insurance Corporation in USA., the scheme of deposit insurance was introduced in Indian with effect from January 1, 1962 by the establishment of Deposit Insurance Corporation by an act of the parliament. With the introduction of credit guarantee scheme, the corporation is renamed as Deposit Insurance and credit guarantee Corporation of India with effect from July 15, 1978. The deposit insurance scheme covers all scheduled and non-scheduled commercial banks and also co-operative banks.

To start with the scheme provided insurance to cover every depositor to the extent of Rs. 15,000 . In respect of each depositor in each bank in the case of a failure of the bank.

Life Insurance :

Human beings face risks and fears. The risk of death is a certain. We are after nagged by certain fears, the fears of uncertain future, the insecurity of not being able to provide adequately for children, the fear of not being able to save enough.

Free Insurance Cover to Savings Bank Account Holder :

In order to induce savers to deposit their savings in savings accounts, leading commercial banks, in public and private sectors have been offering life insurance cover to the account holders. For example, Andhra Bank is offered this facility. The bank makes an arrangement with Life Insurance Corporation of India to provide insurance cover.

13.16 DORMANT ACCOUNTS :

Accounts either savings or current which remain in operative for a considerable length of time are called dormant accounts. If the customers does not create any transaction for a long time, his account is considered as dormant account. It should be noted that law did not prescribe any period after which an account is to be treated as dormant account. Each banks pursues its own policy in this regard.

There may be several reasons for the customer for not doing any transaction. He might have moved out of the place without notifying of the banker his changed address. He might have misplaced the pass book and forgotten about the account. When customers change places, some of them do not mind to leave the balance if the amount is negligible. The other reason can be the depositor might have died and his successors has not bring it to the notice of the banker.

If the account is a running account, the banker sends a statement of account to the customer and may also send a confirmation slip for his signature at regular intervals. In the case of active account, the customer submits pass book from time to time to update entries.

On dormant accounts, there is no control and therefore there is scope for fraud. The bank should transfer all dormant accounts to a separate ledger and the signature cards should be placed under lock and key to avoid manipulations.

13.17 SELF ASSESSMENT QUESTIONS :

Five Marks Question :

1. Minor
2. Joint Accounts

3. Executors and Administrators
4. Trustees
5. Fixed Deposits
6. Savings Accounts and Current Accounts
7. Pass Book
8. Insurance of Bank Deposits
9. Dormant Accounts
10. Fixed Deposit Receit.

Ten Marks Questions :

1. What precautions should a banker take in opening the account in the name of a minor ?
2. What precautions should a banker take in opening an current account of a married women?
3. What precautions should a banker take in opening an accouunt in the name of partner ship?
4. State the specific precaution a banker should take in opening accounts for a joint stock company ?
5. What are various types of special customers ?
6. Describe the steps involved in opening a current or savings account with a bank ?
7. State the bank deposit insurance scheme ?
8. What are current accounts ? Discuss the merits and demerits of opening a current account with a bank.
9. What is pass book ? What are its features ?

Twenty Marks Questions :

1.What are the various types of special customers of a banker ?
2. What precautions are to be taken by a banker while opening accounts in the name of :
   a) Trustees
   b) Joint hindu family
   c) Clubs and Charitable Institutions.
3. Discuss the consequences of wrong entries in the pass book.
4. Discuss the legal implications of fixed deposit receipts.
5. What is pass book ? What are its features ? What is the legal position of entries in the pass book ?
6. “Entries in the pass book constitute an unquestionable record of transactions between the banker and the customer”. Discuss.

13.18 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin’s Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

SRI. V.VIJAY KUMAR.

LESSON - 14

NEGOTIABLE INSTRUMENTS ACT - 1881

14.0 OBJECTIVE :

After Studying this lesson you should be able to understand the following :
(1) What is Negotiable Instruments Act of 1881,
(2) Types of Negotiable Instruments
(3) Defferent kinds of Endorsement

STRUCTURE OF LESSON

14.1 Introduction
14.2 Negotiable Instruments Act
14.3 Characterstic features of Negotiable Instruments
14.4 Types of Negotiable Instruments
14.5 Promissory Note
14.6 Bill of Exchange
14.7 Cheque
14.8 Classification of Negotiable Instruments
14.9 Special Parties to a Negotiable Instruments
14.10 Cheque Vs Bills of Exchange
14.11 Different parts of a cheque
14.12 Proper drawing of a cheque
14.13 Crossing
14.14 Kinds of Crossing
14.15 Endorsement
14.16 Kinds of Endorsement
14.17 Summary
14.18 Self Assessment Questions
14.19 Reference Books

14.1 INTRODUCTION :

A Negotiable Instruments is one, the legal title of which can be transferred by mere delivery or endorsement and by delivery. The title thus transferred, is free from all defects, and the transferee can sue in his own name. In the case of negotiability, change in ownership can take place with ease and without any formality. Thus, negotiability implies “easy transferability from one person to another in return for consideration”.

14.2 NEGOTIABLE INSTRUMENTS ACT :

In India, the negotiable instruments are governed by the Negotiable Instruments Act of 1881. Sec. 13 of the Negotiable Instruments Act simply states that “negotiable instrument means promissory note, bill of exchange or cheque payable either to order or to bearer”. Thus free negotiability is an important characteristic of negotiable instrument.

14.3 CHARACTERISTIC FEATURES OF NEGOTIABLE INSTRUMENTS :

(i) Free Transfer : There is no formality to be complied with for the transfer of a negotiable instrument. It can be very easily transferred from one person to another, either by mere delivery or, by endorsement and delivery.

(ii) Transfer Free from Defects : It confers an absolute and good title on the transferee. Even if the transferor has a bad title to the instrument, he can still pass on a good title to any holder, who takes it in good faith and without negligence and for valuable consideration.

(iii) Right to Sue : It confers a right on the holder to sue in his own name, in case of need.

(iv) Number of Transfers : A negotiable instrument can be transfered any number of times before maturity.

(v) No Notice to Transfer : The transferor of a negotiable instrument can simply transfer the document, without serving any notice of transfer, to the party who is liable on the instrument to pay.

(vi) Presumptions as to Negotiable Instruments : Sec. 118 and 119 of the Negotiable Instruments Act deal with certain presumptions which are applicable only to all negotiable instruments.

14.4 TYPES OF NEGOTIABLE INSTRUMENTS :

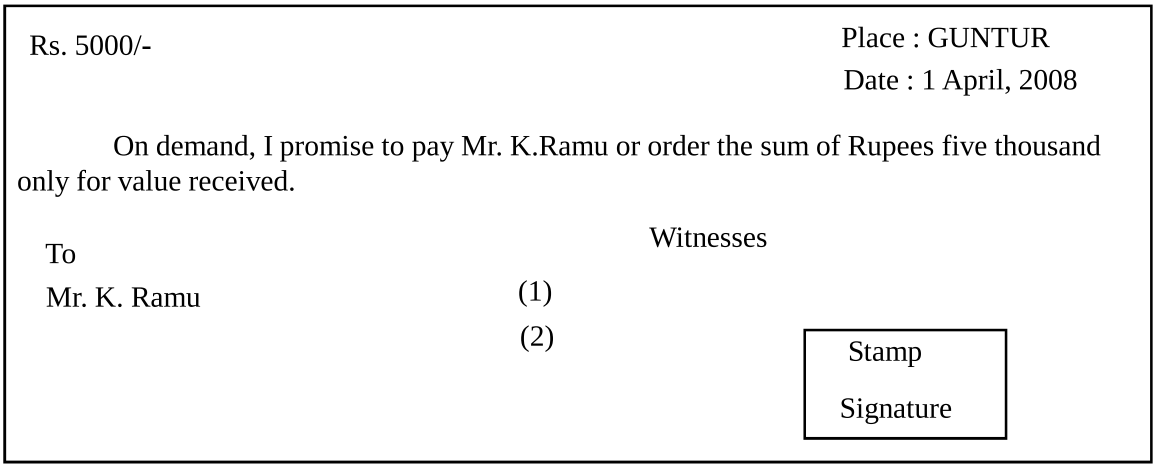
As stated earlier, the Negotiable Instrument can be broadly classified into two viz. : (i) Instrument Negotiable by law, and (ii) Instrument Negotiable by custom or usage of trade.

In India, law recognises only three instruments as negotiable and they are : (i) Promissory Note, (ii) Bill of Exchange, and (iii) Cheque.

14.5 PROMISSORY NOTE :

Sec. 4 of the Negotiable Instruments Act defines a promissory Note as ‘ an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument’.

SPECIMEN OF A PROMISSORY NOTE



Rs. 5000/-

Place : GUNTUR
Date : 1 April, 2008

On demand, I promise to pay Mr. K.Ramu or order the sum of Rupees five thousand only for value received.

To
Mr. K. Ramu

Witnesses
(1)
(2)

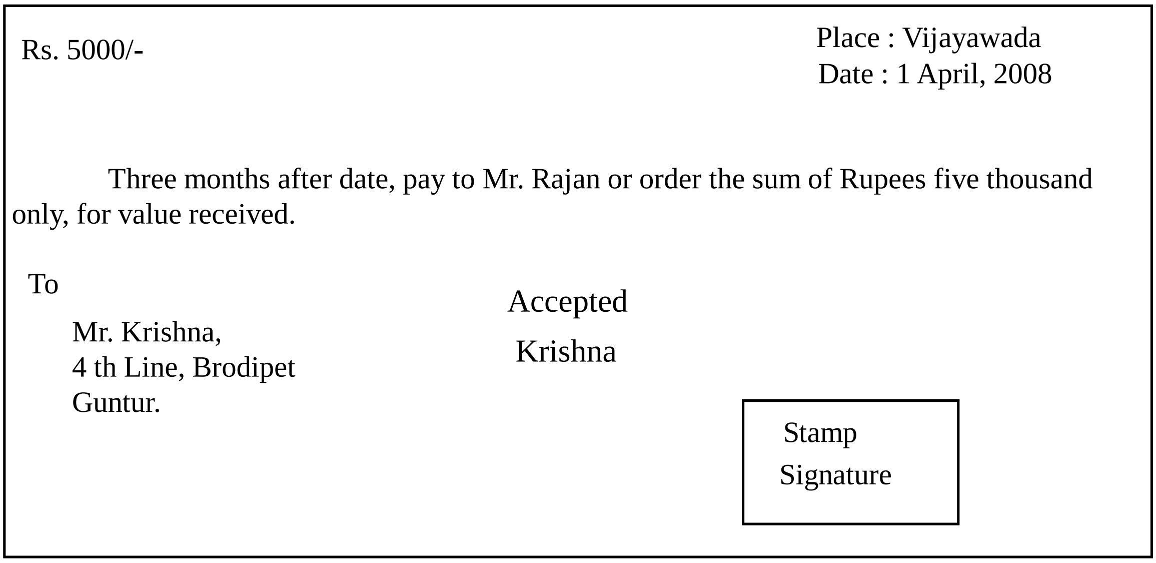
Stamp
Signature

14.6 BILL OF EXCHANGE :

Unlike a promissory note, the bill of exchange contains an order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. Sec. 5 of the Negotiable Instruments Act defines a bill of exchange as follows:

"An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument."

SPECIMEN OF A BILL OF EXCHANGE :



Rs. 5000/-

Place : Vijayawada
Date : 1 April, 2008

Three months after date, pay to Mr. Rajan or order the sum of Rupees five thousand only, for value received.

To
Mr. Krishna,
4 th Line, Brodipet
Guntur.

Accepted
Krishna

Stamp
Signature

14.7 CHEQUE :

In view of its importance to a student of banking, it has been discussed at length at the end of this chapter.

Features of Bill of a Exchange and a Promissory Note :

(i) Instrument in Writing : A bill or a promissory note must be in writing only. Oral orders or promise do not make a valid instrument.

(ii) Unconditional Order/Promise : The 'order' that is stated in the bill and the 'promise' that is given in a promissory note must be unconditional.

(iii) Drawn on a Certain Person : A bill is always drawn on a certain person, preferably, by the seller on his customer (creditor).

(iv) A Certain Sum of Money : The 'order' or the 'promise' must be to pay a certain sum of money. The amount to be paid must be definite.

(a) it includes future interest, or
(b) it is payable at an indicated rate of exchange, or
(c) it is payable according to the course of exchange.

(v) Payee to be Certain : A bill or a promissory note is drawn payable to a certain person or to his order to the bearer of the instrument.

(vi) Payable on Demand or after a Certain Date : A bill of exchange or a promissory note may be payable at sight (demand bill) or after the expiry of a certain period specified therein (time bill).

(vii) Signed by the drawer/ maker : A bill or the promissory note must be signed by the drawer or the maker respectively.

(viii) Delivery Essential : A bill or promissory note is deemed to be drawn only when the person who has prepared it delivers it to the other party to whom it is meant.

14.8 CLASSIFICATION OF NEGOTIABLE INSTRUMENTS :

(a) Bearer vs. Order Instruments :

As per Sec. 11 of the Negotiable Instruments Act, a negotiable instrument is a bearer instrument when (i) it is expressed to be payable to the bearer, or (ii) the only/ last endorsement on it is an endorsement in blank.

Example : A bill is payable to Mr. X or bearer.

As per Sec. 13 (1) of the Negotiable Instruments Act, a negotiable instrument is an order instrument when (i) it is payable to the order of a certain person, and (ii) does not restrict its transfer.

Example : A bill is payable to Mr. X or order.

b) Inland vs. Foreign Instruments :

A negotiable instrument is deemed to be an inland one, when (i) it is drawn and payable in India or (ii) it is drawn upon any person resident in India, irrespective of his place of origin.

(c) Demand vs. Future Time Instruments :

A negotiable instrument is payable on demand when (i) it is expressed to be payable on demand or at sight or on presentment, or (ii) no time is fixed for its payment.

(d) Clean vs. Ambiguous Instruments :

Instruments which can be clearly identified as bill or promissory note or cheque are called clear instruments. But, instruments which can be interpreted either as a bill or promissory note are called ambiguous instruments. It arises mainly because of faulty drafting of the instruments.

(e) Trade vs. Accommodation Bill :

A trade bill originates from a genuine trade transaction. An accomodation bill, on the other hand, is drawn and accepted without any consideration, with a view to help each other.

14.9 SPECIAL PARTIES TO A NEGOTIABLE INSTRUMENT :

(a) Drawee in Case of Need : He is a person, who is willing to take up the liability on a bill, in case the bill is likely to be dishonoured, either due to non-acceptance or nonpayment.

(b) Acceptor for Honour Supra Protest : There is a provision in the Act for a stranger, to take up the liabilities by accepting a bill, which has been noted or protested for non-acceptance or for better security.

14.10 CHEQUES

A cheque is a document of very great importance in the commercial world.

The cheque currency is very popular in all places of commercial importance because of its merits. It is cheaper to print a cheque than a currency note.

Definition of a Cheque : Section 6 of the Negotiable Instruments Act defines a cheque as follows :

“ A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand”.

Cheques vs. Bill of Exchange : The differences between a Cheque and a Bill of Exchange are given very briefly hereunder :

Cheque	Bill of Exchange
(1) A cheque is always drawn on a printed form.	(1) A bill need not be drawn on a printed form.
(2) The drawee (banker) need not accept a cheque. Accordingly there is no privity of contract between the payee and the banker.	(2) Acceptance by the drawee is essential.
(3) A cheque is always supposed to be drawn against the funds in the hands of the banker.	(3) There is no such supposition.
(4) A cheque is an instrument for immediate payment.	(4) It is drawn for a specified period and so it is intended for circulation. Therefore, it is entitled to days of grace.
(5) The liability of the drawer continues for 6 months.	(5) Unreasonable delay in the presentation will discharge the bill.
(6) A cheque is free from stamp duty.	(6) A bill is subject to ad valorem duty.
(7) It is not drawn in sets.	(7) Foreign bills are always drawn in sets.
(8) It may be crossed to ensure safety.	(8) It cannot be crossed.
(9) A cheque may be countermanded.	(9) Countermanding of a bill is not possible.
(10) It is not protested or noted on dishonour.	(10) It is usually protested and noted for dishonour.
(11) In case of dishonour, notice of dishonour to the drawer is not essential.	(11) Notice of dishonour must be sent to hold the party liable.
(12) Statutory protection as given under Sec. 85 and Sec. 131 of the Negotiable Instruments Act applies only to cheques.	(12) Statutory protection is not available in the case of bills.

The Salient Features of a Cheque :

(1) Instrument in Writing : A cheque must necessarily be an instrument in writing. Oral orders therefore do not constitute a cheque. There is no specific rule regarding the writing materials to be used.

(2) An Unconditional Order : A cheque is an order to pay and it is not a request. In the indigenous bill of exchange, words of courtesy with little monetary implications were generously employed.

(3) On a Specified Banker : A cheque is always drawn on a particular banker only. Usually the name and address of the banker is clearly printed on the cheque leaf itself.

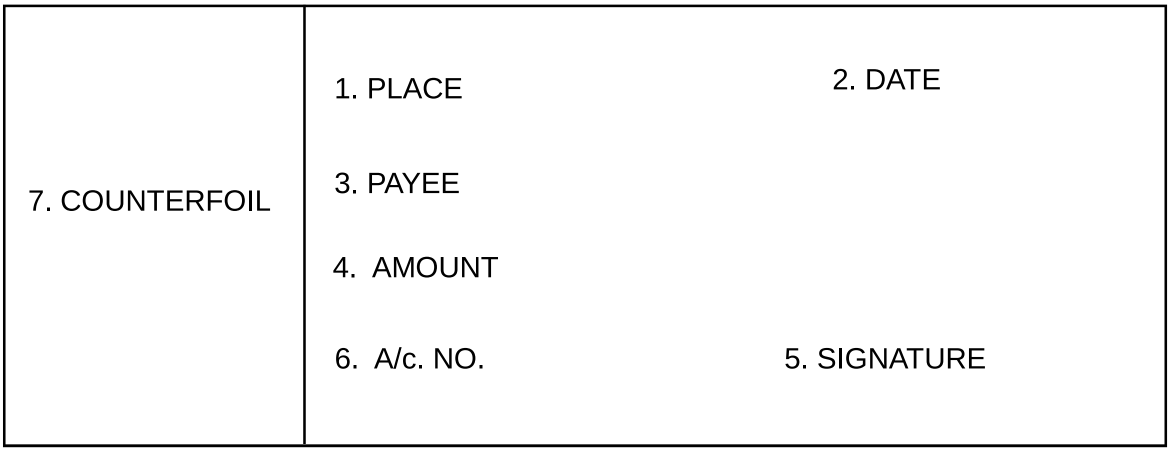
(4) Payee to be Certain : In order that a cheque may be a valid one, it must be made payable to the order of a certain specified person or to his agent or the bearer thereof.

(5) A Certain Sum of Money : A cheque is usually drawn for a definite sum of money. Indefiniteness has no place in monetary transactions.

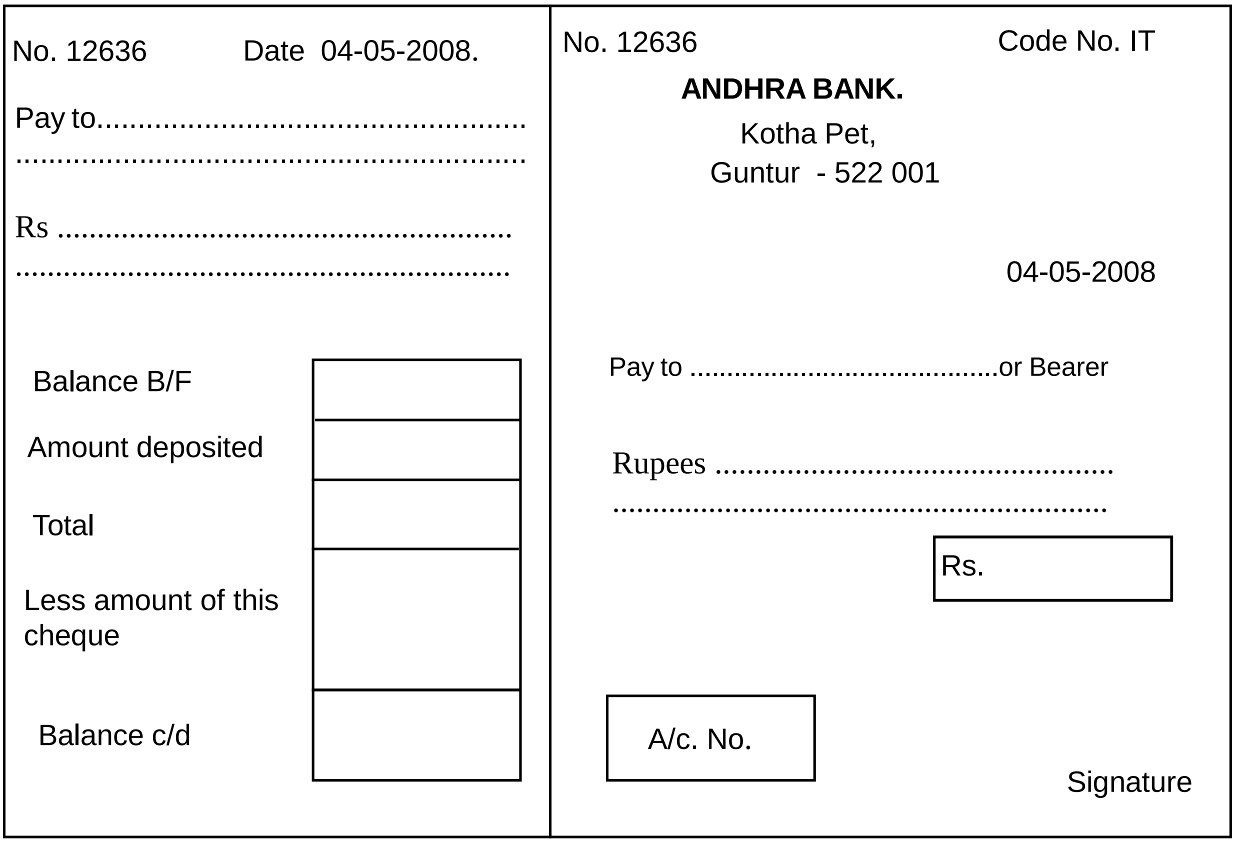
(6) Date : A cheque should bear the date. A cheque without date is incomplete.

(7) Stamp : No stamp is required to be affixed on cheques.

14.11 DIFFERENT PARTS OF A CHEQUE


7. COUNTERFOIL
1. PLACE
2. DATE
3. PAYEE
4. AMOUNT
6. A/c. NO.
5. SIGNATURE

SPECIMEN OF A CHEQUE



No. 12636 Date 04-05-2008.

Pay to..
....

Rs ....
....

Balance B/F	
Amount deposited	
Total	
Less amount of this cheque	
Balance c/d	

No. 12636 Code No. IT

ANDHRA BANK.
Kotha Pet,
Guntur - 522 001

04-05-2008

Pay to ....or Bearer

Rupees ....
....

Rs.

A/c. No.

Signature

8) Payable on Demand : A cheque is always payable only on demand. It is not necessary to use the word ‘ on demand’ as in the case of a demand bill.

(9) To be Signed by the Drawer : The cheque must be signed by the drawer i.e., the customer. The drawer normally puts his signature at the bottom right hand corner of the cheque.

Printed Form :

All banks follow more or less a common form. They supply standard printed forms to their customers. The customer should invariably make use of those cheque leaves and this is one of the conditions laid down in the Pass Book supplied to the customers.

(1) It relieves the customer from the botheration of preparing a cheque leaf.

(2) It minimises the work of the customer.

(3) Forgery on a printed form can be easily detected.

(4) Any alteration on a printed form can be found out more easily than on an ordinary piece of paper.

(5) If a cheque is drawn on a printed form supplied by a banker, countermanding becomes easier because of the serial number.

(6) The counterfoils of a printed form serves as a piece of record.

(7) It would reduce bank operating expenses to a large extent from the point of view of its cost and handling.

Special Printed Forms :

Some banks in the West attract their customers by offering them a special printed cheque form on which their names and addresses are printed.

Some customers request the bankers to attach a receipt form to a cheque. In that case, the payee will have to complete and handover the receipt before receiving the amount of the cheque.

New Provision Under Sec. 138 of the Negotiable Instruments Act :

A new Section 138 has been introduced in the Negotiable Instruments Act, 1881 which comes into effective from 1st April 1989 onwards. This new provision recognises the act of drawing of cheques without sufficient balance in the account of the drawer as a criminal complaint against that drawer.

What Constitutes an Offence ?

(i) The cheque should have been issued to settle a debt or for a consideration.

(ii) The cheque should have been presented within a reasonable period of time i.e., before six months from the date of issue.

(iii) The cheque in question should have been dishonoured only due to the reason of insufficiency of funds in the account of the drawer.

Punishment :

If the drawer is found guilty of a criminal offence under Sec. 138, he would be punishable with an imprisonment of one year or a fine to the extent of twice the amount of the cheque dishonoured or both.

14.12 PROPER DRAWING OF A CHEQUE

1. The Date Column : Date is the first item to be filled in by a customer. The cheque, like any other document in commerce, must bear a date. If the date happens to be a Sunday, it will not affect the validity of a cheque.

Ante Dating and Post-Dating : The date on a cheque may be a current one, or an ante one or a post one. A cheque, which bears a date before the date of issue, is said to be ante dated.

A Banker and a Post-Dated Cheque :

(1) A post-dated cheque cannot be considered as a valid cheque till the date of maturity. As per the definition of a cheque, it is always payable on demand.

(2) The banker who pays a post-dated cheque before its date, disobeys his customer’s mandate, since, a cheque is nothing but a customer’s mandate.

(3) If the banker honours a post-dated cheque before its date, he has no authority to debit his customer’s account until its date.

(4) It is possible that a customer might have issued a cheque with a post-date with an intention to have it countermanded before that date.

(5) Further the marking or certification of a post-dated cheque is not at all valid.

2. The ‘Payee’ Column :

The next important column is the ‘payee’ column. The term ‘payee’ denotes the person to whom the amount of the cheque is payable. As per the definition of a cheque, the payee must be a certain person.

(1) “Pay to -- order”

(2) “Pay to -- or order”
(3) “Pay to -- or bearer”

3. The ‘Amount’ Column :

The law does not say anything about the way in which the amount of a cheque should be indicated. However, the custom is to indicate the amount both in words and figures -- words in the body of the cheque and figures at the left hand bottom.

The amount should always be written clearly with a pen. If there is any overwriting or alteration, it should be confirmed by the drawer himself with his full signature.

4. The ‘Signature Column’ :

Signature is an essential part of a cheque. Without signature, the instrument cannot be regarded as a valid one. A banker usually obtains the specimen signatures of customers at the time of opening new accounts.

14.13 CROSSING

A cheque without crossing is called an open cheque. It is open to many risks. In order to protect it from risks, crossing has been introduced. Crossing originated almost by accident.

In the year 1856, crossing of cheques became a matter of legislation. It was laid down by the 1956 Act:

(i) that, when a cheque is crossed with or without the words ‘ & Co.’ inbetween, it should be presented through some banker, and

(ii) that, when a cheque is crossed in favour of a particular banker, its payment should be made only to that banker or another banker acting as his agent.

But, in Simmons vs. Taylor, it was laid down that crossing was not an integral part of a cheque and that its erasure did not amount to forgery.

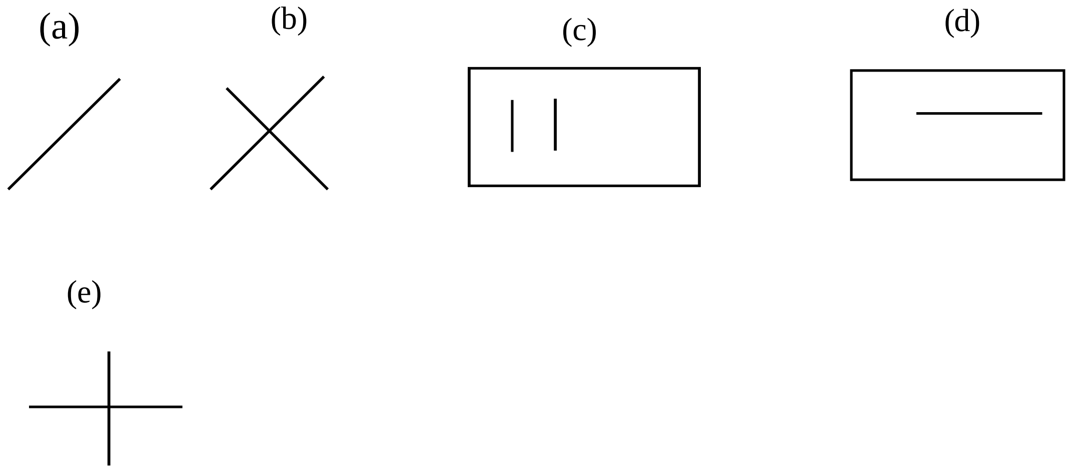
14.14 KINDS OF CROSSING

Crossing is of two types namely General crossing and Special Crossing.

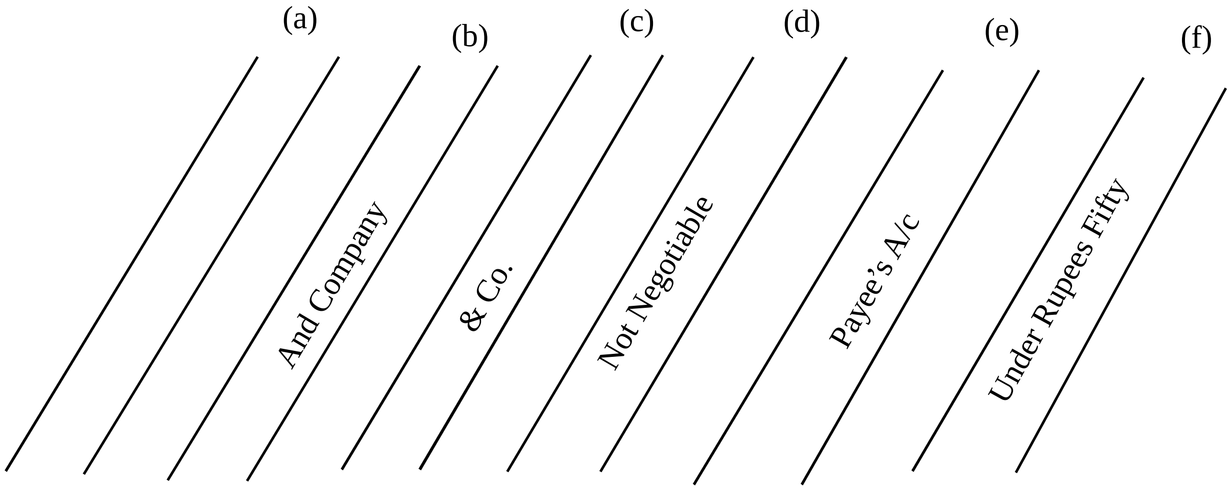
General Crossing : Sec. 123 of the Negotiable Instruments Act, 1881 defines general crossing.

Essentials of General Crossing :

1. Two lines are of paramount importance in crossing.
2. So also, the words ‘Not Negotiable’ may be added to crossing. But, they them selves do not constitute a crossing.



Forms of General Crossing



Significance of General Crossing :

(i) The effect of general crossing is that it gives a direction to the paying banker.

(ii) Sec. 126 of the Act clearly lays down that, " where a cheque is crossed generally, the banker on whom it is drawn, shall not pay it otherwise than to a banker".

(iii) If a crossed cheque is paid at the counter in contravention of the crossing.

(a) the payment does not amount to payment in due course. So, the paying banker will lose his statutory protection,

(b) he has no right to debit his customer's account, since, it will constitute breach of his customer's mandate,

(c) he will be liable to the drawer for any loss, which he may suffer.

(iv) The main intention of crossing a cheque is to give protection to it.

Special Crossing :

Sec. 124 of the Negotiable Instruments Act of 1881 defines a special crossing as follows: “where a cheque bears across its face, an addition of the name of a banker, with or without the words ‘Not Negotiable’, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be crossed to that banker.”

Essentials of Special Crossing :

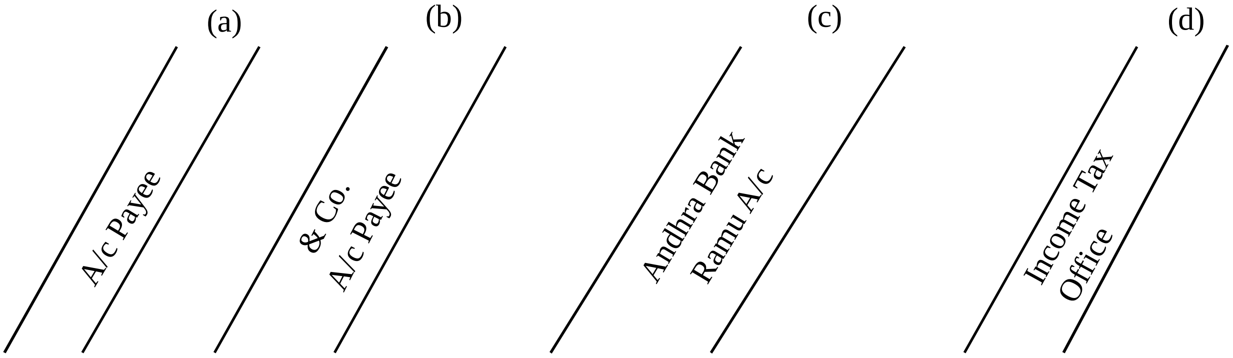
(i) Two parallel transverse lines are not at all essential for a special crossing.

(ii) The name of a banker must be necessarily specified across the face of the cheque.

(iii) It must appear on the left hand side, preferably on the corner, so as not to obliterate the printed number of the cheque.

(iv) The two parallel transverse lines and the words ‘Not Negotiable’ may be added to a special crossing.

Forms of Special Crossing :



Significance of Special Crossing :

(i) It is also a direction to the paying banker. The direction is that, the paying banker should pay the cheque only to the banker, whose name appears in the crossing or to his agent.

(ii) If a cheque specially crossed to a bank is presented by another bank, not in the capacity of its agent, the paying banker is justified in returning the cheque.

(iii) A special crossing gives more protection to the cheque than a general crossing. It makes a cheque still safer because, a person, who does not have a real claim for it, would find it difficult to obtain payment.

Not Negotiable Crossing :

As stated earlier, Sec. 123 and 124 of the Act permit the use of the words ‘Not Negotiable’ in the crossing. This type of crossing is termed as ‘Not Negotiable’ crossing.

Thus, a cheque crossed ‘Not Negotiable’ can be transferred like any other cheque. But the transferee cannot obtain a better title than that of the transferor.

The words ‘Not Negotiable’ do not impose any additional duty on either the collecting banker or the paying banker.

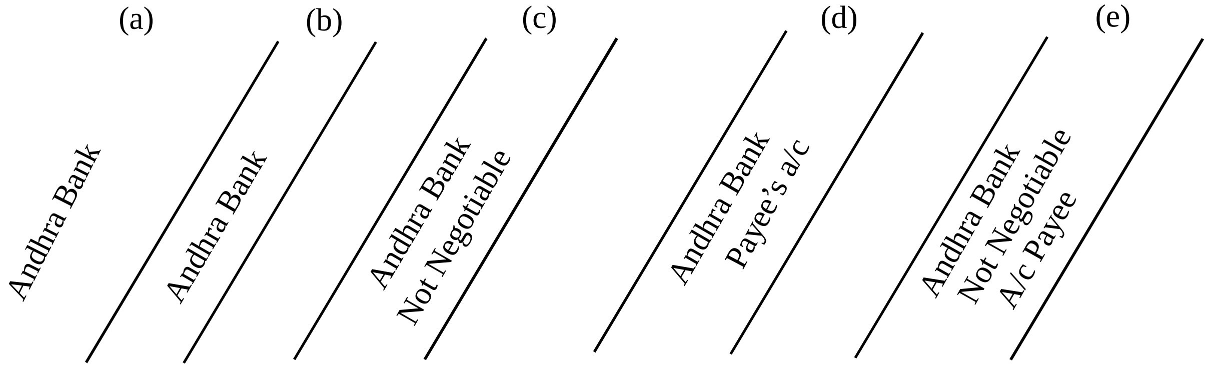
The object of this type of crossing is to give protection to the true owner of the cheque by preserving his right against any subsequent holder. So, this type of crossed cheques can safely be sent through post.

To put it in nutshell, if a cheque is crossed ‘not negotiable’ , it is taken out of the category of negotiable instruments. But, it can be transferred subject to the title of the transferor.

A/c Payee Crossing :

There is no provision in Law regarding this type of crossing. But it has been developed in practice. If the words, ‘A/c payee’ are added to a crossing, it becomes an A/c payee crossing.

Forms of A/c Payee Crossing



Significance of A/c Payee Crossing :

‘A/c payee’ crossing does not restrict the transferability of cheques. In American Bank vs. Andrew Brothers, the drawer of a cheque (Andrew Brothers) pleaded that, since, the cheque had been marked A/c payee only, the negotiation on it was null and void.

This type of crossing gives a further protection to a cheque. This crossing gives a direction to the collecting banker.

If a collecting banker collects such a crossed cheque for any person other than the payee, it will constitute negligence on the part of the collecting banker, and so, he will lose the statutory protection given under Sec. 131 of the Act.

Double Crossing :

Sec. 125 of the Act provides that " Where a cheque is crossed specially, the banker to whom it is crossed, may again cross it specially to another banker, his agent for collection".

Who Can Cross a Cheque :

(i) The drawer of a cheque can cross it at the time of issuing it.

(ii) Any holder can cross an uncrossed cheque. He can convert general crossing into special crossing, and, he can even add the words 'Not Negotiable' or 'A/c payee' to a crossing.

(iii) The banker in whose favour a cheque has been crossed, can again cross it in favour of another banker, for the purpose of collection as an agent.

14.15 ENDORSEMENT

Transfer of Cheque :

However, a cheque can be transferred both in India and England in settlement of a debt. It means that, the value represented by the instrument can be transferred from person to person. This transfer of a cheque can be effected depending upon the nature of the instrument. Endorsement is nothing but the process of signing one name or affixing an accepted rubber stamp impression on a cheque, for the purpose of transfer.

Does a Bearer Cheque Require an Endorsement :

Possession of a bearer cheque is a conclusive evidence of the bearer's ownership. A bearer cheque, in a strict legal sense, does not require endorsement. However, in practice, bankers request the holder of a bearer cheque to endorse it, before obtaining payment. There is no justification in compelling a holder of a bearer cheque to endorse it compulsorily before encashing it.

Definition of Endorsement :

Significance of Endorsement :

An endorsement consists of two contracts namely, (i) contract of transfer of the property in the instrument, and (ii) contract of a contingent assumption of liability on the part of the endorser.

(i) He had a good title to it.

(ii) It was genuine in all its particulars at the time of his endorsement.

(iii) All the previous endorsements were genuine. Thus, Sec. 122 of the Negotiable Instruments Act provides that "no endorser of a negotiable instrument shall, in a suit thereon by a subsequent holder, be permitted to deny signature or capacity to contract of any prior party to instrument."

Assignment Vs. Endorsement :

(i) An Assignment means the transfer of legal title to a property. Endorsement not only means the transfer of legal title, but also, it includes the assumption of liability.

(ii) In the case of assignment, the assignee's title is subject to the title of the assignor.

14.16 KINDS OF ENDORSEMENT :

(a) Blank Endorsement : According to Sec. 16(1) of the Negotiable Instruments Act "if the endorser signs his name only, the endorsement is said to be "Blank"... "An endorsement in blank, as it is generally called General endorsement, specifies no endorsee, and as such, the instrument becomes payable to the bearer."

(b) Special Endorsement : It is otherwise called a full endorsement. Sec. 16(1) of the Negotiable Instruments Act lays down that "... if he (endorser) adds a direction to pay the amount mentioned, to or to the order of a specified person, the endorsement is said to be in "full" and the person so specified is called the endorsee of the instrument."

(c) Restrictive Endorsement : A restrictive endorsement is one which limits the further negotiation of an instrument. The endorsee in such cases cannot further endorse it. Generally, the word 'only', is added after the endorsee's name.

Example : A cheque is payable to K.Ramu. He endorsees it as follows:

(a) 'Pay to Krishna only' -- Ramu.
(b) 'For deposit only' -- Ramu.
(c) 'Pay to the order of Samuel' -- Ramu.

(d) Partial Endorsement : If only a part of the amount of the instrument is endorsed, it is a case of partial endorsement. According to Sec. 56 of the Negotiable Instruments Act -- "No writing on a negotiable instrument is valid for the purpose of negotiability, if such a writing purports to transfer only a part of the amount appearing to be due on the instrument."

Regularity of Endorsement :

Complimentary and Courtesy Title : An endorsement should be in the form of an ordinary signature of the payee or endorsee. Complimentary prefixes and suffixes and other courtesy titles should not form a part of the endorsement.

14.17 SUMMARY :

A negotiable instrument is one, the legal title of which can be transferred by mere delivery or endorsement and delivery. In India, the negotiable instruments are governed by the Negotiable Instruments Act of 1881. In fact, law recognises only three kinds of Negotiable Instruments, namely, a cheque, a Bill of Exchange and a Promissory Note. But, certain other documents have been included in this category due to mercantile usage or custom. The characteristic features of a Negotiable Instruments are free transfer, transfer free from defects, transfer without notice, right to sue, pledging of the credit of the party etc.

A cheque without crossing is called an open cheque. It is open to many risks. To avoid such risks, crossing has been introduced. Broadly speaking, crossing is of two types, namely General Crossing and Special Crossing.

The process of signing one’s name on the back of a cheque for the purpose of its transfer is called an endorsement. Sec. 15 of the Negotiable Instruments Act defines an endorsement. In case sufficient space is not available on the back, a piece of paper can be attached to the instrument and subsequent endorsement may be made on that paper. The paper so attached is called ‘Allonge’.

14.18 SELF ASSESSMENT QUESTIONS :

Five Marks Questions :

1. Post-dated cheque.
2. What are the features of a cheque.
3. Endorsement in Bank.
4. Negotiable Instrument.
5. Account payee crossing.
6. Endorsement.
7. Promisory Note.

Ten Marks Questions :

1. What are the different types of crossing of cheques ?
2. What are the various features of cheques ?
3. Crossing of cheques ?
4. What are negotiable instruments ? What are their features ?
5. Describe the types and features of negotiable instruments ?
6. What is the difference between a cheque and bill of exchange ?

Twenty Marks Questions :

1. What are the essential features of a promisory note as per the Negotiable Instrument Act 1881 ?

2. Define a cheque. Explain the characteristics of a cheque ?
3. What is meant by endorsement ? Elucidate the types and features of endorsements.
4. What is meant by crossing of cheque ? Explain different types of crossing and their significance.
5. Explain the sailent features of Negotiable Instrument Act of 1885.

14.19 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin's Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

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LESSON - 15

LIABILITIES OF BANKER

15.0 OBJECTIVE :

After studying this lesson you should be able to understand the following :

(1) Liabilities of a Banker
(2) Duties and Responsibilities of Collecting Banker.
(3) Protection of Collecting Banker Sec. 131

STRUCTURE OF LESSON

15.1 Introduction
15.2 Paying Banker
15.3 Precautions to be taken by a Paying Banker
15.4 Duties and Responsibilities of Collecting Banker
15.5 Collecting Banker as a holder for value
15.6 Collecting Banker as a agent
15.7 Statutory Protection to collecting banker Sec.131
15.8 Banker's Negligence
15.9 Forged Endorsement
15.10 Summary
15.11 Self Assessment Questions
15.12 Reference Books

15.1 INTRODUCTION :

A banker is one who does banking business. The Banking Regulation Act, 1949, defines banking as, "accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise." According to **Hart,** " a banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current accounts".

Thus, it is the prime duty of a banker to honour the cheques of its customers. Besides that, a banker may also agree to collect cheques of its customers on their behalf. The liability of a banker, mainly from these two angles, has been discussed below :

15.2 PAYING BANKER :

The relation between a banker and his customer is that of a debtor and a creditor. Banker does not enjoy the position of a trustee of the money deposited with him by the customer.

Section 31 of the Negotiable Instruments Act provides "the drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and in default of such payment, must compensate the drawer for any loss or damage caused by such default.” Thus a banker should be very cautious both at the time of honouring as well as dishonouring his customer’s cheques.

15.3 PRECAUTIONS TO BE TAKEN BY A PAYING BANKER WHILE HONOURING CHEQUES

In order to protect its as well as the customer’s interests, the paying banker should take the following precautions while making payment of his customer’s cheques :

1. Form of the cheque : The cheque should be in proper form. The Negotiable Instruments Act does not give the form of a cheque but most banks in India provide in their rules of operating accounts that the cheque must be drawn in the printed forms supplied by the banks and the banks reserve the right of dishonouring a cheque in case it is not in the prescribed form.

2. Open or Crossed Cheque : The most important precaution that a banker should take is about crossed cheques. A banker has to verify whether the cheque is open or crossed. He should not pay cash across the counter in respect of crossed cheques. If the cheque is a crossed one, he should see whether it is a general crossing or special crossing. If it is a general crossing, the holder must be asked to present the cheque through some banker. It should be paid to a banker.

3. Date of Cheque : The banker should refuse to honour an undated cheque which has been presented to it for payment. The date need not be filled in by the drawer, it can be filled by the subsequent holder too.

Post-dated Cheques : In case a cheque is post dated *i.e.* it bears a date which is yet to come, the bank should honour it only on or after the date mentioned on the cheque *e.g.* if a cheque is drawn on 15th September and bears the date of 15th December, the cheque is post-dated and it should be honoured by the banker, not earlier than 15th December.

Stale Cheque : That is also termed as an ‘Out-of-date cheque.’ It is the custom of the bankers not to pay cheques which are presented after a certain period has elapsed since the apparent date of their issue.

4. Amount of the Cheque : The banker should see that the amount mentioned both in figures and words in the cheque are the same. In case they differ, the amount stated in words may be taken as correct and the banker may make the payment.

5. ‘Funds’ of the customer : There should be sufficient funds in the account of the customer for payment of the cheque. Cheque has to be paid in full and not in part and, therefore, inadequacy of funds will result in dishonour of the cheque unless the banker has granted loan or advance to the customer to that extent or more than the amount of deficit.

The cheques should be paid in chronological order of their receipt by the bank. The date of their issue or serial number is not significant in this respect.

6. Precaution Regarding Material Alteration : The term ‘material alteration’ has already been explained in the previous pages. In case a cheque is materially altered and the banker makes the payment, he shall be discharged from liability only when he proves the following :

(i) The alteration could not be detected with reasonable care, prudence and scrutiny, and

(ii) The payment had been made in due course.

7. Drawer's Signature : A banker, is expected to know the signatures of his customers and, therefore, if the drawer's signature has been forged, and the banker makes the payment it shall not be entitled to debit the customer's account with the payment.

It is also expected from the customers to remain reasonably vigilant and tender all possible assistance to the bank when asked by it, *e.g.,* if the signatures of the drawer are forged and the bank seeks the drawer's confirmation about the cheque, the drawer confirms the issue of cheque without himself verifying and the bank makes the payment, the bank will not be liable.

8. Mutilated Cheques : A cheque is said to be mutilated when it is torn into two or more pieces. Such a cheque should not be paid unless the banker is satisfied that mutilation was unintentional and it also obtains confirmation of the drawer.

9. Banking hours : The banker should make payment of only such cheques which have been presented to it for payment during its banking hours. Any payment of cheque which was presented after banking hours will not be taken as a payment in due course and the banker will not be entitled to debit the customer's account if in the meanwhile the customer has countermanded the payment or some similar event had happened.

10. The Branch and the Balance : The banker should verify whether the cheque is drawn on it or on some other branch of the same bank. A banker has to honour cheques which are drawn on it only but not on any other bank or branch.

11. Scrutiny of Endorsements : Negotiable Instruments are transferred by delivery or by endorsement and delivery. While bearer instruments can be transferred by mere delivery, order instruments require endorsement and delivery.

15.4 COLLECTING BANKER :

15.4 Duties and Responsibilities of Collecting Banker :

A banker is under no legal obligation to collect cheques and bills on behalf of its customers. But every modern bank collects cheques and bills on behalf of its customers in order to provide a service to them.

15.5 COLLECTING BANKER AS A HOLDER FOR VALUE :

A banker becomes holder for value of a cheque in the following circumstances :

(1) When a banker pays the amount of a cheque drawn on another bank, before collection,

the collecting banker is treated as a holder for value.

(2) Where he receives a cheque in specific reduction of the amount due from the customer; and

(3) where the banker has a lien on the cheque.

When a banker becomes a holder for value his rights are the same as of other holder for value. In other words, he will be entitled to receive the amount of the cheque from the drawee in his own right and in case of dishonour from one or all of the endorsers.

15.6 COLLECTING BANKER AS AGENT :

When the banker undertakes to collect the cheque of a customer without becoming a holder for value or a holder in due course, he acts as customer’s agent.

The collecting banker acting as an agent of his customer does not possess title to the cheque better than the customer.

1. Examination of Cheques and Endorsement : As an agent of the customer, the collecting banker is bound to show reasonable care and deligence in the collection of cheques.

2. Presentment of Cheques for Collection : The collecting banker must present the cheques received for payment within a reasonable time to the drawee-bank. According to banking practices, if the collecting and paying banks are in the same place, the collecting bank should present the cheques by the next day.

3. Information to the Customer about Collection : It is the duty of the collecting banker, unless otherwise agreed, to inform the customer the amount collected and credited to his account. The collecting bank must follow the instructions of the customer in this regard.

4. Serve Notice of Dishonour : When a cheque is dishonoured, the collecting banker must give notice of dishonour to the customer. This is usually done by returning the cheque to the customer with a covering letter. In practice return of the unpaid cheque to the customer is regarded as sufficient notice.

5. Precautions to Avoid Conversion Charge : The collecting banker has also responsibility to work in the interest of the owner of the cheque, although there is no contractual relationship between him and third parties. If the customer is not the true owner of the cheque, the collecting banker cannot get a better title as he is only an agent.

15.7 STATUTORY PROTECTION TO COLLECTING BANKER -- Sec. 131:

A banker may undertake to collect a cheque either as a holder for value or merely an agent to the holder. “When a banker acts as an agent, he gets no better title than his customer.

Statutory Protection : Section 131 of the Negotiable Instruments Act provides protection to a collecting banker who receives payment of a crossed cheque or draft on behalf of his customers. According to Section 131 of the Act “a banker who has, in good faith and without negligence, received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment”.

The collecting banker is given protection under Section 131 in case of collection of crossed cheques against forged endorsements. This protection can be claimed provided the banker received payment (1) in good faith (2) without negligence (3) for a customer (4) of a cheques crossed generally or specially to himself.

‘A banker receives payment of a crossed cheque for a customer within the meaning of this Section, not withstanding that he credits his customer’s account with the amount of the cheque before receiving payment thereof’.

Unless the collecting banker can claim protection under the above section, he becomes liable for conversion when he collects cheques belonging to the customer. He will be entitled to protection only under the following circumstances :

1. The cheque should have been crossed before it came into his possession.

2. He must have received payment in his capacity as agent of the customer and not in the capacity of a holder.

3. He must have received payment only for a customer.

4. He must have acted in good faith and without negligence. The onus of proving the absence of negligence rests on the banker.

The above points are discussed in detail below :

1. The Cheque must have been crossed before it came into the possession of the collecting banker. No protection is given to the collecting banker in respect of open cheques, presumably because the holder of an open cheque does not require the services of a banker for obtaining payment.

2. The banker can claim protection only in respect of cheques collected for his customers. The term ‘customer’ has been defined earlier, and the persons for whom cheques are collected must come within the meaning of the term defined.

3. The banker must have received payment in his capacity as the agent of the customer. If he becomes a holder for value he cannot get the protection. Till the decision in Capital Countries Bank *v.* Gordon (1903), bankers used generally to credit the customer’s account with the cheques deposited for collection.

“The banker receives payment of a crossed cheque for a customer within the meaning of the section, notwithstanding that he credits his customer’s account with the amount of the cheque before receiving payment thereof ".

4. The banker must have acted in good faith and without negligence. The terms refer to the whole conduct of the banker during the entire period of the transaction, *i.e.* from the time or receiving the cheque for collection till it is credited to the customer's account.

15.8 BANKER'S NEGLIGENCE :

1. Opening of New Accounts without Proper Introduction : While opening a new account the banker must obtain satisfactory introduction of the new customer about his true identity and respectability.

2. Irregularity of Endorsements : The collecting banker has to ensure that all the endorsements on cheques presented to him are regular. It was held in one case that the collecting banker was negligent in not detecting that an endorsement and signature to a receipt on a cheque did not correspond with the name of the payee.

3. Commission to Verify per Pro. Signatures : The banker should be careful in accepting for collection cheques bearing signs per procuration. He should make an enquiry in cases where an agent

draws on behalf of his principal and pays them into his own account.

4. Disregard of the Warning on the Face of the Cheque : If the banker disregards the warning on the face of the cheque by a person who had authority to do so if it is paid into his personal account, the banker have to lose the statutory protection.

5. Collecting for a Partner's Private Account Cheques Payable to the Partnership : The banker has no right to assume that a partner is entitled to place to his own account cheques payable to the firm.

6. Placing to a Customer's Personal Account Cheques Payable to him in an Official or Fiduciary Capacity : If cheque are drawn in favour of his official capacity and he says that they be credited to his private account the banker should enquire into the circumstances of the transaction.

7. Collection of Crossed Cheques Bearing Account Payee Crossing : The banker should not disregard the directions conveyed by general or special crossing.

8. Collecting Cheques Paid in at One Branch for a Customer who had an Account at another Branch of the same Bank : In *Loyds Bank Ltd., Vs. V.E.B. Savory & Co.,* crossed bearer cheques drawn by Savory &Co., in favour of third parties misappropriated by two of the bank employees and paid into a branch of the Loyds Bank to be credited to their accounts kept at other branches.

9. Collecting for a private account of an official or agent : A cheque made payable to his company or firm and endorsed by him as agent on its behalf has been regarded to be an act of negligence in several cases.

15.9 Forged Endorsement :

(a) Uncrossed Cheques : A Banker paying a cheque bearing a forged endorsement is protected under Sec. 85. This Section is an exception to the rule that 'Forgery conveys on title'. It relieves the bankers from their responsibility in the case of forged to endorsements. Under this section, when a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee *e.g.,* the banker is discharged by payment in due course. But the person receiving the payment is liable to refund the amount to the true owner. In the case of cheques originally expressed to be payable to bearer is discharged by payment in due course to the bearer thereof (Sec. 85A). Thus in such cases, the banker can safely ignore the endorsement.

In cases when the banker has to refuse to honour cheques, the payment by him cannot be a payment in due course and will not relieve his liability to the true owner. Further, he cannot ignore a patent irregularity in the endorsement. He should not disregard the instructions received from the customer. The banker should also note that he can claim protecction against the forgery of the endorser's signature and not that of the drawer's signature.

(b) Crossed Cheques : In the case of crossed cheques also, he gets protection provided he makes a payment in due course. He should have made the payment to a Banker, if the cheque is crossed generally, and the Banker to whom it is crossed, if it is crossed specially. He must refuse payment, if it is crossed specially to more than one banker. If he pays contrary to the crossing, he cannot debit the account of the drawer. Moreover he becomes liable to the true owner.

15.10 SUMMARY :

A collecting banker is one who undertakes to collect cheques for his customer. All crossed cheques have to be necessarily collected by a banker. In collecting a cheque, the banker has to act only as an agent of the customer and not as a holder for value. As an agent, if he collects a cheque which belongs to some other person, to the account of his customer, he would be held liable for 'conversion'. Conversion is a criminal offence and the person committing it is personally liable. To safeguard the interest of a collecting banker, and to save him from the liability of conversion, statutory protection has been extended to him under Sec. 131 of Negotiable Instruments Act.

15.11 SELF ASSESSMENT QUESTIONS :

Five Marks Questions :

1.Paying Banker.
2.Collecting Banker.
3.Dishonour of a cheque.
4. Payment in due course.
5. Collecting banker as a holder for value.
6. Negligence.

Ten Marks Questions :

1. Can a banker recover money paid by mistake on a cheque ?
2. What is the legal position of (liability) a banker in paying a cheque bearing forged endorsement.
3. What do you understand by Marking of Cheques ?
4. What is ment by payment in due course ?

Twenty Marks Questions :

1. What do you mean by payment of cheques ? Explain the precautions a paying banker should take while honouring cheques of his customer.
2. Under what circumstances can a banker dishonour a cheque of a customer ? What are the consequences of wrongful dishonour ?
3. What do you mean by payment of cheques ? Explain the legal position of a paying banker with regard to payment of cheques.
4. What are the precautions taken by banker at the time of payment ? How does the Act provides statutory protection.

15.12 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin's Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

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LESSON - 16

LOANS AND ADVANCES

16.0 OBJECTIVE :

After studying this lesson you should be able to understand the following :

(1) What is Loans and Advances
(2) Different types of Loand and Advances.
(3) What Precautions should be taken by Banker

STRUCTURE OF LESSON

16.1 Introduction
16.2 General Principles of Sound Lending
16.3 Forms of Advances
16.4 Classification of Loans and Advances
16.5 Secured Advances
16.6 Modes of Creating a Charge of Security
16.7 Lien
16.8 Pledge
16.9 Mortgage
16.10 Hypothecation
16.11 Secured Advances Modes of Creating Charge
16.12 Difference between Lien and Pledge
16.13 Summary
16.14 Self Assessment Questions
16.15 Reference Books

16.1 INTRODUCTION :

Commercial banks act as financial intermediaries between the saving public and investors. The finanacial resources mobilised by banks will be lent to various productive sectors in the form of loans and advances. A bank faces several risks in granting loans and advances. Banks therefore follow a cautions policy and follow the principles of sound lending of funds. The loans and advances should be repaid as per the terms and conditions and on time. If there are delays in payment interest or principal the loan becomes non-performing asset. Bad and doubtful debts impair the profitability of banks and adversly affect the capital base.

16.2 GENERAL PRINCIPLES OF SOUND LENDING :

Since all loans entail a credit risk, the banks have to follow the following principles :

(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.

(2) Liquidity : Liquidity is nothing but the ability of a banker to convert an 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 long periods are less liquid because they cannot be received back in times of need. 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.

(4) Security : No banker sees the horoscope of a customer and lends. He calculates his lending risk and lend. To minimise the chances of risk, security should be insisted upon. The security must be adequate, easily realisable and free from encumberances.

(5) Purpose of the Loan : Another important cannon 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.

(6) Diversification of Risks : Since every loan entails some risk element, it is advisable to spread the credit risk. This can be done by granting moderate loans to a large number of customers, spreading over a wide area. In other words, a banker would not concentrate all his loanable funds in one industry or one particular area or a group of few customers only.

(7) Assured Repayment : A banker should come forward to lend only when the repayment is assured. When there is default in repayment, a banker's ability to create further credit is affected. Hence, while advancing money, he should see the source of repayment.

(8) 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.

(9) The Law of Limitation Act : A lending banker should also bear 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.

16.3 FORMS OF ADVANCES :

The loans and advances granted by banks can be broadly divided into the following categories :

(i) Loans.
(ii) Cash credit.
(iii) Overdraft.
(iv) Discounting of Bill 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.

Short-term, Medium-term and Long-term Loans :

These loans may be short-term loans or medium-term loans or long-term loans.

(ii) Cash Credit : Under this system, a customer is permitted to borrow money upto a particular limit against sufficient securities. 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. Interest on cash credit is charged only on the actual amount utilised. However, there is a minimum interest clause or a commitment charge.

(iii) Overdraft : 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.

(iv) Discounting of Bills : Under this type, the banker lends money against the bill of exchange or a promissory note. A holder of a bill has to wait, till the maturity of the bill, say three months, to realise the amount of the bill.

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.

(v) Hire Purchase 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.

16.4 CLASSIFICATIONS OF LOANS AND ADVANCES :

According to the Banking Regulation Act, 1949, the loans and advances granted by banks can be broadly classified into two namely :

(i) Secured Advances, and
(ii) Unsecured Advances.

Secured Advance : As per Sec. 5(i)(n) of the Banking Regulation Act, 1949 “Secured loan or advance means a loan or advance made on the security of assets, the market value of which is not, at any time, less than the amount of the loan or advance”.

Unsecured Advance : The Banking Regulation Act again points out that “Unsecured loan or advance means a loan or advance not so secured”. It means, in the case of unsecured advances, loans are granted without any tangible securities.

Character : The character of the borrower takes the place of a tangible security in unsecured advances. A banker grants loan relying upon his character only.

Capacity : The success of this type of loan to a large extent depends upon the borrower's capacity to run the business successfully. This inturn depends upon his technical competence, managerial skill and his experience in that trade or industry.

Capital : The borrower should have sufficient capital at least to start a venture. Then only he will have some stake in the business. Generally, the bank provides finance for the working capital requirements of the business.

16.5 SECURED ADVANCES :

As stated earlier, 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.

Cannons of a Good Banking Security :

(i) Free from Encumberances : The borrower should have an absolute title over the property offered as security.

(ii) Easy Marketability : The security offered must be such, that, it is easily marketable without loss in its value.

(iii) Easy Storability : Again, the securities should not pose a problem of storage to a banker.

(iv) Durability : The banker must see whether the security possesses the quality of durability. Durable goods alone can be stored for a reasonable period.

(v) Free from Price Fluctuation : An ideal security is one which is free from wide price fluctuations. When the price of the security falls suddenly, the value of the security becomes lesser than the amount of the loan granted.

(vi) Essay Ascertainment of Value : The security must be capable of being valued without much difficulties. For example, daily market reports are available for certain securities like gold, silver, stock exchange securities etc.

(vii) Earning of Income : Again, a good security must be capable of earning income. Such incomes can be appropriated towards the loan amount.

(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 : Moreover, 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.

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.

(i) Validity of the Title of the Borrower : First of all, the banker must ascertain whether the borrower has a good title to the security.

(ii) Nature of the Security : The banker should pay attention to the nature of the security. He must see whether the security possesses all the qualities of a good security as discussed earlier.

(iii) Free from Defects : In the case of secured advances, a banker relies more on the security, rather than, the creditworthiness of the borrower.

(iv) Documentation : The lending function of a banker must be adequately supported by appropriate documents. Therefore, documentation is an important step in bank lending.

Generally, the 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 continuity 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, promising 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.

(v) 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 retains some amount as margin.

Importance of Margin : Adequate margin has to be maintained on securities due to the following reasons :

(i) The loan amount is going on increasing year after year, since, the interest is added to it. But, the value of the security remains the same or it even comes down.

(ii) On the other hand, the value of the security is going on decreasing year after year due depreciation, deterioration in quality etc.

Margin for Different Kinds of Securities :

(i) Gold and Silver : Generally gold and silver have a permanent demand in the market. Moreover, their value is not subject to wide price fluctuations. Therefore, a banker is justified in keeping a low margin of 10% to 15%.

(ii) Stock Exchange Securities : Margin for stock exchange securities depends upon the type of the company to which the share belongs

(iii) Government Securities : Government securities like loan bonds. Treasury bills are called guilt edged securities. They are very much demanded in the market.

16.6 MODES OF CREATING A CHARGE OF SECURITY

The way by which a banker obtains control over the security is called 'modes of charging'. If the security is not properly charged in favour of a banker, he will remain as an unsecured creditor.

The following are the important methods of charging :

(i) Lien, (ii) Pledge, (iii) Mortgage, and (iv) Hypothecation.

16.7 LIEN :

Lien has been already discussed in detail under the chapter "banker and customer". According to Sec. 171 of the Indian Contract Act, it is nothing but a right to retain the property of the customer, given as security, till the loan is repaid.

16.8 PLEDGE :

Sec. 172 of the Indian Contract Act defines pledge as follows :

"The bailment of goods as security for payment of a debt or performance of a promise". The person who pledges the property is called the pledger or bailor or pawner. The person to whom the property is bailed is called the pledgee or bailee or pawnee. Sec. 172 lays down the following conditions :

(i) There must be bailment of goods.

(ii) The intention of bailment is to provide security for the payment of a debt.

(iii) When the debt is repaid, goods must be returned.

Essential Features of a Pledge :

To constitute a valid pledge, the following conditions must have been fulfilled :

(i) Delivery of Goods : Without the delivery of goods, there cannot be any pledge at all. It means that, the securities should have been delivered to the banker, at the time of getting an advance.

(ii) Transfer of Possession : Under pledge, the pledger transfers only the possession of goods, subject to a charge, and not his ownership to the goods.

(iii) Existing Goods Only : A pledge can be created only in respect of existing goods, which are in the possession of the pledgee. There cannot be any bailment 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 within the specified period.

(v) Agreement : An agreement in writing between the pledger and the pledgee for creating a charge is essential, though not necessary.

(vi) Right of Lien : So long as the loan together with the accrued interest thereon is not paid, the pledgee has a right to retain the possession of the goods pledged. No other creditor of the pledger has any right to take away the goods from the pledgee, before the loan due to him is paid.

(vii) Redelivery of Goods : Once the loan is repaid, the goods under pledge must be redelivered to the borrower. In *Dhanalakshmi Bank Ltd., K.K. Jose Alias Mohan (1993)* it was held that, if the pledgee bank is not in a position to redeliver the pledged good, he is not entitled to sue on the debt and realise the amount due.

Advantages of Pledge :

(i) Simple Formality : The formalities connected with the creation of a pledge are simpler than that of a mortgage.

(ii) Easy to Sell : Since the pledged goods are in the custody of the banker as a pledgee, he can easily sell them in the market, in case of any default.

(iii) No Double Financing : Again, it will not be possible for the pledger to pledge the same goods and get another loan from another bank.

(iv) 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.

(v) Protection from Loss : In case of any loss or damage to the pledged property, the banker can recover the amount from the insurance company.

Precautions : Though pledge is the most satisfactory method of creating a charge, a banker has to take the following precautions :

(i) Ensure Ownership : First of all, the banker should ensure that the pledger is the real owner of the pledged goods.

(ii) Take Reasonable Care : The pledgee banker must take a reasonable care of the pledged goods, in such a way that, an ordinary prudent man would take of his own goods.

(iii) Exercise Full Control : The banker should exercise full control over the pledged property.

(iv) No Unauthorised Use : The banker should not make any unauthorised use of the pledged property.

(v) Put up Signboards : The banker should put up a signboard at the place, where the goods are kept, prominently showing that the goods are pledged to the banker.

(vi) Draft the Agreement Carefully : The banker must carefully draft the agreement, while creating a charge by way of pledge.

16.9 MORTGAGE :

A mortgage is a method of charging which can be created only in respect of immovable properties like land and building.

Definition : According to Sec. 58 of the Transfer of Property Act, 1882 :

“A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to pecuniary liability”.

Essential Features of a Mortgage :

(i) Immovable Property : As per the above definition, a mortgage can be effected only in respect of immovable properties.

(ii) Transfer of Interest in the Property : Creation of a mortgage requires the transfer of interest in a specific immovable property.

(iii) Specific Property : The interest to be transferred is always with respect to a ‘specific property’. In other words, the property must be made specific through proper identity like its size, location, boundaries etc.

(iv) Possession with the Mortgager : The actual possession of the mortgaged property is with the mortgager. He need not always transfer it to the mortgagee.

(v) To Secure a Loan : As per the definition, the object of creating a mortgage is either to secure a loan or to perform an engagement. But, a banker is vitally concerned with the first objective, namely, to secure a loan.

(vi) Reconveyance of Interest : On repayment of the loan together with interest, the interest in specific immovable property is reconveyed to the mortgager.

Kinds of Mortgages : The Transfer of Property Act recognises the following types of mortgages:

(i) Simple mortgage.
(ii) Mortgage by conditional sale.
(iii) Usufructuary mortgage.
(iv) English mortgage.
(v) Mortgage by deposit of title deeds.
(vi) Anomalous mortgage.

(i) Simple Mortgage : Under this type,

(a) The mortgager does not transfer the possession of the property. But, he promises to pay the mortgage money.

(b) In the event of his failure, he permits his property to be sold through the intervention of the court. Hence, no power of sale is available, in this case, without the interven tion of the court.

(ii) Mortgage by Conditional Sale : This type of mortgage is created subject to certain conditions. The essential features are :

(a) The mortgager ostensibly sells the property to the mortgagee, on condition that this sale would become void on payment of the mortgage money.

(iii) Usufructuary Mortgage : Under this type of mortgage :

(a) The mortgagee is authorised to retain the possession of the property till the loan is repaid.

(b) He is also authorised to receive the income like rents and profits arising from that property.

(iv) Mortgage by Deposit of Title Deeds : This type of mortgage is called equitable mortgage. Under this type :

(a) There is a mere deposit of title deeds to property.

(b) The intention of the deposit is to secure a loan.

16.10 HYPOTHECATION :

Hypothecation is otherwise called 'mortgage of movable property'. This method of charge has been evolved in banking practice. Manufacturing concerns cannot pledge their raw materials which are required for daily production.

Features :

(a) No Transfer of Possession : Under hypothecation, the physical possession of goods always remains with the borrower. Actually, the banker gets only the constructive possession.

In *Gopal Singh, Hira Singh Vs. Punjab National Bank* and Another, it was held that under hypothecation, the physical possession of goods remains with the borrower, while the bank enjoys only constructive possession through the deed of hypothecation.

(b) No Transfer of Ownership : There is also no transfer of ownership of goods to the banker. The ownership always remains with the borrower.

(c) Obligation to Repay a Debt : Under hypothecation, there is an obligation on the part of the borrower to repay a debt.

(d) 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.

Drawbacks : Hypothecation meets with the following 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 very easily indulge in fraudulent activities.

(b) False Stock Statements : The borrower may give false and inflated stock statements, against which, he may enjoy over credit facilities. In fact, some of the stocks may contain even obsolete items.

(c) Double Financing : The borrower may hypothecate the same stocks of goods with different banks and get different loans, since, there is no necessity of physically transferring the goods to the banker.

16.11 SECURED ADVANCES MODES OF CREATING CHARGE

Meaning :

While granting loans the banker relays more on the purpose of the loan than on the character of the borrower. But the nature of security provided by the borrower continues to be an important consideration for granting loans. If the borrower fails to repay the loan, the banker can recover the amount due by disposing of the security. In such cases, the bank acquires certain rights in the tangible assets over which a charge is created. There are several modes of creating a charge -- Lien, pledge, hypothecation and mortgage. We describe below the features of these different types of charges.

The different modes (types) of creating charge are :

1. Lien, 2. Pledge, 3. Hypothecation, 4. Mortgage, 5. Assignment, 6. Guarantee.

LIEN :

One of the statutory rights of the banker is to exercise General Lien. A lien is a right of the creditor in possession of goods, securities or any other assets belonging to a debtor to retain them until the debt is charged provided there is an agreement express or implied to the contrary. A general lien confers only a right to the creditor to retain goods until the debt is discharged but it does not give the right to sell.

The lien is of two types (*i*) general lien and (*ii*) particular lien. A particular lien arises out of a contract where goods can be retained by the creditor in respect of a particular debt only.

Bankers Lien :

Apart from any specific security, the banker can look to his general lien as a protection against any loss on loan or overdraft or other credit facility. In Brando *Vs* Barnett (1846) it is stated as under :

"Bankers must undoubtedly have a general lien on all securities deposited with them as bankers by custom, unless there is an express contract or implied contract in extence contrary to the lien.

PLEDGE :

Section 172 of the Indian Contract Act, 1872 defines pledge as "bailment of goods as security for payment of a debt or performance of a promise." The person who offers the security is called the pawner or pledger and the bailee is called 'pawnee' or pledgee. Thus in the case or pledge (*i*) there must be bailment of goods, and (*ii*) the objective of such bailment should be to hold the goods as security for the payment of a debt or the performance of a promise.

Who can Pledge :

1. The owner of the goods himself or his mercantile agent may pledge the goods. Where a person pledges goods in which he has only a limited interest, the pledge is valid only to the extent of that interest.

2. A seller who is left in possession of goods after sale and a buyer to whom possession has been given before the price is paid can also create a pledge.

3. Joint owner with the consent of coowners can also pledge.

Rights of the Banker : The banker who becomes the pledgee has to right to retain the goods pledged for the amount advanced, the interest thereon and the expenses incurred by him in connection with the possession or preservation of the goods pledged.

If the proceeds of the sale are insufficient to discharge the debt, the banker can recover the balance from the pledger. If the amount realised is greater, the banker should pay over the surplus to the pledger. The pledger of the goods must disclose the faults in the goods which are within his knowledge.

Duties of the Banker : The banker is bound to return the goods on payment of the debt. He is responsible for any loss, destruction or deterioration of the goods if they are not returned at the proper time. While in possession of the goods pledged, he should use than only according to the agreement he makes with the pledger.

Bailment of Goods : Section 148 of the Indian Contract Act defines bailment as the “delivery of goods from one person to another for some specific purpose upon the contract that the goods be returned back when the purpose is accomplished or otherwise disposed of according to the instructions of the bailor.

16.12 DIFFERENCE BETWEEN LIEN AND PLEDGE

Lien	Pledge
1. It is a right to retain the security-property or goods.	1. It gives the right to hold goods for the payment of a debt or performance of a promise.
2. The property must be owned by the person.	2. The person who pledges the property need not be the actual owner. He may be an agent, who can be pledge with owner’s consent.
3. In an ordinary lien the creditor has no right to sell the goods in his possession. But thebanker has the power to sell goods/securities in certain cases as the banker’s lien is an implied pledge.	3. The pledgee has the power to sell. He has to account to the pledgor for any surplus that remains after clearing the debt.
4. There must be physical delivery of the property or securities.	4. Physical delivery is not essential. There may be symbolic delivery which is having legal effect of actual delivery.

HYPOTHECATION :

Hypothecation is another method of creating a charge on movable goods. Hypothecation is a legal transaction in which goods are given as security for, a debt without transfering either the property in them or the position to the lender. In the case of hypothecation the borrower retains the possession of the goods.

Precautions to taken while Granting Loans on Hypothecation :

The banker has to take utmost care in granting loans against hypothecation. It is a risky one because the borrower may fail to give possession of the asset to the banker when he demands it or he may sell the asset without repaying the loan to the banker or he may hypothecate the same asset with another banker.

1. The borrower's character, capacity and capital must be thoroughly verified. Unless the borrower satisfies the three attributes, loan shall not be granted on the basis of hypothecation.

2. An undertaking that the same goods under hypothecation are not charged to other creditor.

3. A name plate stating that the goods are hypothecated to particular bank should be put in a prominent place near the stock of goods.

4. The goods shall be insured against loss due to fire, theft and other risks.

5. The borrower shall be asked to submit at periodical intervals a statement of the stock of goods held by him under hypothecation. Bank officials should check the stock of goods at periodical intervals.

6. The banker should get the charge registered under section 125 of the Companies Act, if the debtor happens to be a joint stock company. An undertaking given under the seal of the company that a second charge against the same property will be not be created should also be registered with the registrar.

16.13 SUMMARY :

A major part of the money lent by a banker comes from the deposits. These deposits are repayable on demand. Again, all loans entail a credit risk. Hence, a banker should follow certain general principles while lending money. He must take into account principles like safety, liquidity, profitability, security, purpose of the loan, diversification of risk, source of repayment and social objectives. The loans granted by a banker may mainly take the form of loan or cash credit or overdraft or bills discounted.

16.14 SELF ASSESSMENT QUESTIONS :

Five Marks Questions :

What is :

1. Cash Credit
2. Overdraft
3. Unsecured Loan

4. Secured Loan
5. Lien
6. Pledge
7. Mortgage.

Ten Marks Questions :

1. What is Cash Credit ? What are its advantages and limitatioins ?

Twenty Marks Questions :

1. What are the principles of sound lending ?
2. What are the general principles guiding bankers lending policies ? What factors does a banker consider in appraising a project before granting a loan.
3. Explain the procedure for appraisal of a credit proposal by banks.
4. What are the canons of good banking security ?

16.15 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin’s Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

SRI. V.VIJAY KUMAR

LESSON - 17

ADVANCES AGAINST COLLATERAL SECURITIES

17.0 OBJECTIVE :

After studying this lesson you should be able to understand the following :
(1) Different types of Loans and Advances
(2) Duties and Liabilites of banker while advancing loans

STRUCTURE OF LESSON

17.1 Introduction
17.2 Mortgage
17.3 Advances Against Goods
17.4 Documents of Title to Goods
17.5 Life Insurance Policies
17.6 Stock Exchange Securities
17.7 Banker's Receipt
17.8 Supply Bills
17.9 Land and Building as Security (Real Estate)
17.10 Advances against Life Policies
17.11 Summary
17.12 Self Assessment Questions
17.13 Reference Books

17.1 INTRODUCTION

Generally, banks advance money against certain securities. These securities may be broadly classified into two viz,. personal and tangible. Advances against personal securities are in the form of Unsecured advances, wherein, the customer simply executes a promissory note or accepts a bill of exchange.

17.2 MORTGAGE :

When a customer offers immovable property like land and buildings as security for a loan, charge there on is created in the form of a mortgage.

Mortgage Defined : Section 58 of the Transfer of Property Act defines a Mortgages as 'the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt or the performance of an engagement which may give rise to a pecuniary liability'.

Features of Mortgage :

1. There must be transfer of an interest in specific immovable property. There is no transfer of ownership or property.

2. This transfer must be for a debt or obligation.

3. The immovable property must be specific, specified in the mortgage deed. Mention must be made regarding the name, location and size of properties.

4. The object of transfer of interest by mortgage is to secure a loan. An existing over draft can also be secured by mortgage of property. Total transfer of property in dis charge of a loan is not mortgage.

5. The mortgagee not to be given possession of property.

6. The mortgagor gets back all rights over the property when the loan is repaid.

Forms of Mortgages :

Section 58 recognised different forms of mortgages and specifies rights and liabilities of each of the parties thereto. From the point of view of transfer of title to the mortgaged properties, mortgages can be divided into three categories : (1) Simple mortgage (2) Legal mortgage and (3) Equitable mortgage.

1. In Simple Mortgage : The mortgagor undertakes to pay the mortgage money. He does not deliver the possession of the mortgaged property, but agrees that the mortgagee shall have the right to cause the mortgaged property to be sold and the proceeds of sale applied in payment of the mortgage money to the extent required. In case of default, he has the right to apply to the court for permission to sell the mortgaged property or to recover the whole amount without selling the property.

2. Legal Mortgage : In the case of legal mortgage, the mortgagor transfers legal title of the mortgaged property in favour of mortgagee by a deed. On the repayment of mortgage money, the titled to the mortgaged property is retransferred to the mortgagor.

3. Equitable Mortgages : In this form the legal title to the property is not passed on to the mortgagee. The mortgagor transfers the documents of title of the mortgagee for the purpose of creating an equitable interest of the mortgage in the property.

A mortgage which does not fall into any of the above categories is called an anomolous mortgage in which the rights and liabilities of the parties are determined by their contract as evidenced in the mortgage deed, and if such contract does not exist, by local usage.

Rights of Mortgagor :

The following are the rights of the mortgagor :

1. Right of Redemption : The mortgagor has a right to redeem the mortgaged property under the following conditions :

(i) He pays or tenders the money due on mortgage on the due date at the proper place and time.

(ii) Provided his right has not been terminated on account of the act of parties or decree of the court.

2. Transfer to Third Party : The mortgagor can ask the mortgagee to transfer to the third party the mortgaged property instead of retransference to the mortgagor. the existence of the following conditions is necessary for the execution of this right.

(i) The right of redemption is still subsisting.
(ii) The mortgagee is in the possession of property.
(iii) The right to get it retransferred is a clear condition in the mortgage deed.

Rights of the Mortgagee :

The rights of Mortgagee are specified in the Transfer of Property Act, 1882. They are :

1. Right to Foreclosure or Sale : Foreclosure means debarring the mortgagor from exercising his right of redemption. It can be exercised by obtaining a decree from the court. This right can be exercised at any time after the mortgagee money has become due to him or in the absence of any contract to the contrary.

2. Right to sue for Mortgage Money : Under Section 68, the mortgagee has a right to sue for the money in the following cases :

(a) Where the mortgagor binds himself to pay the money.

(b) Where the mortgaged property is wholly or partially destroyed or security is rendered insufficient and the mortgagor has failed to provide further security to make the whole security sufficient.

(c) Where the mortgagee is deprived of the whole or part or his security by or in consequence of the wrongful act or default of the mortgagor or

(d) Where the mortgagee being entitled to the possession of mortgaged property, the mortgagor fails to deliver the same.

3. Right to Sell without Court Intervention : The mortgagee has the power to sell the mortgaged property or a part there of without the intervention of the court in the following cases :

(i) Where the mortgage is an english mortgage provided neither party is a Hindu, Muslim or Buddhist.

(ii) Where the power to sell without the intervention of the court is conferred in the mortgage deed and the mortgagee is government or the mortgaged property or any part there of was, on the date of the execution of the mortgage, is situated in kolkata, Chennai, Mumbai or any other town or area which the State Government may specify in this belief.

4. Right to the Accession to Mortgage Property : Section 70 enables the mortgagee to hold, for the purpose of security, any accession to the mortgaged property, which occurs after the date of mortgage, if there is no agreement to the contrary.

5. Right to sue and Right to Realise the Security are Distinct Rights : The mortgagee possess the right to sue the mortgagor and also sue for the realisation of security. When ever a loan is taken on mortgage deed, the mortgagor subjects the property mortgaged to a liability of being sold for realisation of the loan by the creditor and at the same time binds himself personally for payment of the loan.

Banker's Preference For Equitable Mortgage :

When a banker receives the title deeds as security for a loan, he gets an equitable title. The mortgage becomes of property. It is effected by the deposit of title deeds with or without a memorandum of deposit or by a Memorandum, showing an intention to create a charge over the property, (H.P. Sheldon). Mere verbal promise is not sufficient.

17.3 ADVANCES AGAINST GOODS :

Now-a-days, most of the loans are secured against goods. 'Goods' is a broader term which includes 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.

Advantages :

(i) Tangible Security : Goods are tangible securities, and so, they are better than guarantees. They can be sold in the market, when the borrower makes a default.

(ii) Easy Ascertainment of Prices : The prices of goods can be ascertained very easily, because, daily market reports are published in papers or announced through radio.

(iii) No Price Fluctuations : The price of most of the goods, which constitute the necessaries of life, are more or less steady.

(iv) Short Period Advance : Advances against goods are always given for short periods, because, most of the goods cannot be stored for a long period. So, they satisfy the cannon of liquidity.

(v) Easy to Create a Charge : A charge over goods can be created very easily and with minimum of formalities. It does not require any registration of documents, payment of stamp duty etc., as in the case of real estate.

Drawbacks :

However, these goods are not without risks. The following are some of the drawbacks attached with goods.

(i) Risk of Storage and Verification : The banker is in absolute need of godowns to store the goods, which have been pledged to secure a loan.

(ii) Risk of Fraud : There are greater risks of fraud as regards quantity and quality. Goods of good quality may be mixed up with inferior quality.

(iii) Risk of Deterioration : The nature of most of the goods are such, that, they are subject to deterioration in quality over a period of time.

(iv) Risk of Price Fluctuations : The value of the security is subject to heavy price fluctuations. During harvest season, there is a glut in the market.

(v) Heavy Transport Cost : When the borrower makes a default, these goods have to be brought to the market for sale. It involves transportation of goods. The transport cost is always high in India.

(vi) Risk of Prior Charge : Prior charge may exist in respect of the same goods. In such a case, the banker will lose his security.

Precautions :

In view of the above drawbacks, a banker should be very cautious while granting advances against goods. He should take the following precautions :

(i) Character of the Borrower : First of all, the banker should take into account the honesty, integrity and trustworthiness of the borrower.

(ii) Experience in the Business : The banker should also find out whether the borrower has sufficient experience in the particular trade in which he has engaged himself in.

(iii) Purpose of the Loan : The banker must enquire into the purpose for which the loan is sought. The repayment of any loan depends upon the purpose for which it is required.

(iv) Title of the Borrower : The banker should ascertain whether the borrower has a genuine title to the goods. This can be done by verifying the invoices or cash receipts.

(v) Nature of Goods : The banker should pay a special attention to the nature of goods as well. Some of the goods are such, that, their prices go up when they are in stock for long periods.

(vi) Proper Valuation of Goods : Adequate care should be taken to value the goods. It is on this basis of valuation, margin is fixed. Hence, a banker can appoint even experts to value the goods.

(vii) Prices in Different Markets : The prices prevailing in different markets will have a tendency to affect the prices in the local market.

(viii) Proper Storage : Necessary care should be taken to see that the pledged goods are properly stored. As far as possible, the godowns should be situated near the bank, so that, the banker can have an easy access to it for inspection.

(ix) Care in a Rented Godown : If the goods are stored in a rented godown, the banker must establish his prior lien with the owner of the building by means of an agreement.

(x) Bank's Name Board : The godowns containing pledged goods must be locked by the bank's padlock.

(xi) Godown Keys : The godown keys must be handled very carefully. On no account, they should be handed over to the customer.

(xii) Adequate Insurance : All goods subject to a charge must be insured upto the full market value of the goods.

(xiii) Periodical Inspection : The banker should conduct periodical inspection to see that the quality and quantity of goods in stock tally with the records maintained by both the banker and the customer.

(xiv) Strict Supervision over the Release of Goods : Sometimes, the borrowers may be allowed to repay the loan in instalments. In such a case, he should ensure that the goods released are only in proportion to the amount of loan repaid.

(xv) To Deal with the Owner of Goods : The banker should always deal with the owner of goods or agents in possession of goods, while creating a charge on goods.

17.4 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 following are the important documents of title to goods :

(i) Bill of lading.
(ii) Railway Receipt / Lorry Receipt.
(iii) Dock Warrant.
(iv) Warehouse keeper’s certificate
(v) Delivery order.

Features of Documents of Title to Goods :

(i) 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.

(ii) These documents, except the warehouse keeper’s certificate, carry with them a right of ownership to goods. Hence, a possessor of this document gets the right of ownership to goods represented by the document.

(iii) 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’.

(iv) A transfer of this document represents a symbolic transfer of goods. Hence, it can be offered as a good banking security.

In Official Assignee of Madras Vs. Mercantile Bank of India Ltd., it was held that pledging of a Railway receipt amounts to pledging of the goods represented by the Railway receipt.

Advantages :

Since these documents are drawn against goods, they simply represent goods. Hence, all the advantages of goods are automatically applicable.

(i) Reliable Security : Since pledging of a document amounts to pledging of goods, it serves as a reliable security. It has the backing of goods.

(ii) Convenient Security : It can be handled very conveniently. The person, who is in possession of this document, can transfer the goods to any person by mere endorsement and delivery without the necessity of any physical transfer of goods.

(iii) Less Formalities : It can be easily transferred without much formalities. Since it is a quasi- negotiable instrument, it can be transferred by mere endorsement and delivery.

Drawbacks :

Advances against documents of title to goods are also subject to certain risks. They are :

(i) Greater Risks of Fraud : There are greater risks of fraud as regards the contents of packages. Generally, the carrier of goods does not give any guarantee as to the contents of packages.

(ii) Greater Risk of Dishonesty : Again, dishonest persons can easily alter the number of packages given on the document and their values.

(ii) Forgery of Endorsement : In case of the endorsement on the document happens to be a forged one, the bankers cannot get any right of ownership to the goods covered by that document, since, the rule is “forgery conveys no title”.

(iv) Partly Negotiable Documents : These documents are not treated as fully negotiable securities. In fact, they are called ‘quasi-negotiable securities’, since, they possess only one quality of the negotiable instrument viz., transfer by endorsement and delivery.

(v) Right of Unpaid Vendors to Stop Goods in Transit : Under the Sale of Goods Act, the unpaid vendor has a right to stop goods in transit, provided, the buyer has become insolvent and the goods have not yet been delivered to him.

(vi) Delivery of Goods without Documents : There is a possibility of taking delivery of goods without surrendering the document.

(vii) Bogus Documents : Of late, there is a tendency among borrowers to deposit bogus R/R or L/R with a view to defraud the banker.

Precautions :

In order to avoid the above risks, the banker should take the following precautions :

(i) Honesty and Integrity : Since the scope for fraud is greater, the banker should see whether the borrower is honest, reliable and trustworthy.

(ii) Genuine Documents : The banker should thoroughly examine the documents to ascertain whether they are genuine or bogus ones.

(iii) Genuine Endorsement : The banker should also see whether the endorsement on the document is genuine.

(iv) Endorsement in Blank : The banker should insist upon the borrower to endorse the document in blank.

(v) No Onerous Clauses : The banker should also ensure that the documents do not contain any onerous or risky clauses like 'containers leaking', 'defective packages' etc.

(vi) Packer's Certificate : The carrier of goods do not give any guarantee as to the contents of packages.

(vii) Adequate Insurance : The banker should see that the goods are adequately insured to the full market value against all risks due to fire, theft, damage in transit, marine risks etc.

(viii) Notice to Issuing Authority : The banker should inform the issuing authority concerned about the creation of a charge on the document.

(ix) Memorandum of Charge : The banker should also obtain a memorandum of charge duly signed by the borrower.

(x) Care in Releasing the Document : It is not advisable on the part of a banker to part with the documents before the repayment of the loan.

(xi) Additional Precautions in the Case of Bill of Lading :

(a) Get all Copies : Generally, a bill of lading is drawn in sets of 3 or 4 on condition that if one accomplishes its purpose, others stand to be cancelled. This is done mainly to avoid the risk of loss in transit through post.

(b) Avoid Freight to Pay Document : The banker should avoid freight to pay bill of lading, because, the captain of the ship will have a prior lien over the goods in respect of the freight charges due.

(xii) Additional Precautions in the Case of a Railway / Lorry Receipt :

(a) Genuine One : The banker should carefully examine it with a view to establish its genuineness.

(b) Goods at Railway Risk : He must also see whether the goods are carried at owner's risk or railway risk. He should prefer R/R at railway risk only.

(c) Information to Railway Authorities : It is always advisable to give notice to the railway authorities about the creation of a charge on goods covered by the R/R.

(d) Date of R/R : The banker should pay particular attention to the date of the R/R. If it is an old one, there is every possibility to pay demurrage charges, and hence, it is not preferable.

(xiii) Additional Precautions in the Case of a Warehouse Keeper's Certificate :

(a) Licensed Warehouse : First of all, the banker must see whether the warehouse is a licensed one or not. It it is not a licensed one, he should not accept the receipt as a security.

(b) Notice to the Warehouse-keeper : The banker should inform the warehouse-keeper about the creation of a charge on the goods in the warehouse, so that, he may not deliver the goods against the instructions of the customer.

(c) Memorandum : While accepting the receipt as a security, the banker should get a memorandum from the borrower. In the memorandum, the borrower must specifically state that he is the absolute owner of the goods and he would not take delivery of the goods without repaying his debt.

(d) Receipt in the Name of the Banker : A warehouse receipt is not at all transferable, since, it is a mere acknowledgment of receipt of goods only. Hence, it is always advisable to get a fresh receipt in his name before granting any advance.

17.5 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 wholelife policy) or after the expiry of a fixed period or death whichever is earlier (in the case of endowment policy).

A life policy gives protection to the family members in the case of untimely death, and at the same time, it acts as a sort of investment, if death does not occur.

Advantages :

(i) Tangible Security : Life policy is better than guarantees, since, it is a tangible security. So long as the premiums are paid regularly, the banker need not worry about this security.

(ii) Highly Liquid : The life insurance company is always ready to pay the surrender value at any time. Hence, the policy can be converted into cash in a moment's notice at the discretion of its holder.

(iii) Easy Valuation : The value of a life policy can be easily ascertained by the banker by making an enquiry with the life insurance company.

(iv) Appreciation in its Value : The value of a life policy is going on increasing year after year, since, the surrender value goes on increasing year after year.

(v) Assured Source of Repayment : The security can be easily realised when the borrower makes any default. In the case of death also, the loan amount can be easily adjusted with the maturity value of the policy.

(vi) No much Legal Formalities : The policy can be assigned in favour of the banker very easily by means of giving a notice of assignment to the company.

(vii) No price Fluctuation : The value of this security is not subject to price fluctuations as in the case of stock exchange securities. Hence, a banker need not worry about the price movements.

(viii) Easy to Ascertain the Title : Generally, a policy is taken by a person on his 'own life'. So, it is easy to find out the title of the borrower.

(ix) No Bogus Policies : In India, the life insurance business is done by the Life Insurance Corporation of India only.

Drawbacks :

Though there are many advantages, there are certain drawbacks associated with life policies. They are :

(i) Non-payment of Premia : There is no guarantee for the regular payment of premia by the borrower. If the premium is not paid regularly, the policy will lapse. If the policy lapses, the insurance company is free from its liability

(ii) Non-disclosure of Material Facts : All insurance contracts are contracts of uberrimae fidei i.e., maintenance of utmost good faith. It means, that the assured should have disclosed all material facts affecting his life, at the time of taking out a policy.

(iii) Absence of Insurable Interest : One of the essential conditions of a life insurance contract is that, there must be insurable interest at the time of taking out a policy.

(iv) Risk in Suicide Clause : Sometimes, a policy may contain some onerous clauses like 'suicide clause'.

(v) Chance for a Duplicate Policy : There is a chance for the borrower to obtain a duplicate policy from the company stating that he has lost his original policy.

(vi) Non-admission of Age : The premium to be payable is determined on the basis of one's age. So, it is necessary that the age of the assured should have been admitted by the insurance company.

Precautions :

If the following precautions are taken into account, life policies can be very well accepted by bankers :

(i) Policy in Force : First of all, the banker should see whether the policy is in force or not. In other words, the policy should not have been lapsed. He must see that the premiums have been paid upto-date. It can be verified by means of checking the latest premium receipt.

(ii) Existence of Insurable Interest : The banker should also ensure that the borrower has an insurable interest. There is no problem if the policy is taken on his own life.

(iii) Admission of Age : The premium to be paid depends upon the age of the person, whose life has been insured. Hence, at the time of taking out the policy, the age of the assured should have been admitted by the company.

(iv) Preference to Endowment Policy with Profit : As between a whole life policy and an endowment policy, the banker should prefer an endowment policy, because, it matures within a stipulated period and the banker is very definite about the source of repayment.

(v) Existence of Prior Encumberance : The existence of any prior charge on the policy would affect the banker's interest. Hence, he should ascertain from the company that there are no encumberances on the policy.

(vi) Proper Care in Creation of Charge : A charge may be created on the life policy either by a legal charge or an equitable charge. Loans can be obtained by simply depositing the policy with the banker.

17.6 STOCK EXCHANGE SECURITIES :

Stock exchange securities refer to those securities which are regularly bought and sold in a stock exchange market. The securities traded on the floor of a stock exchange are :

(i) Securities issued by the Central and State Governments like loan bonds, Treasury bills etc.

(ii) Securities like debentures and bonds issued by the semi-government organisation such as port trust, electricity boards, municipalities etc.

(iii) Shares and debentures issued by joint stock companies.

Advantages :

(i) Easy to Ascertain the Title : The title of the borrower can be easily ascertained. In the case of registered securities, the name of the title holder is inscribed on the document itself. Again, it is recorded in the 'register' kept for this purpose by the company.

(ii) Easy to Ascertain the Value : The market value of these securities can be easily ascertained from the 'share market reports' published daily in the newspapers.

(iii) Reliable Securities : Shares of good companies and Government securities are in great demand in the market. Their prices go up almost everyday and the they carry a steady dividend also.

(iv) Liquid Securities : Since there is a ready market, they can be realised within a very short period. In case the borrower makes any default, these securities can be disposed off in the market very quickly, and thus, liquid cash can be obtained.

(v) Safe Securities : Generally, the prices of good companies shares do not fluctuate very much. The guilt edged securities are not very much affected by business cycles.

(vi) Negotiable Securities : Securities like bearer securities, share warrants and government promissory notes are fully negotiable. They can be transferred by mere delivery and their transfer does not require any stamp duty.

(vii) Income Yielding Securities : All these securities earn income in the form of interest and dividend. The greatest advantage is that, these incomes can be appropriated towards the loan amount.

(viii) Free from much Legal Formalities : The formalities connected with the creation of a charge on these securities are very simple. One has to simply execute the transfer form in the case of registered securities.

(ix) Less Expensive : Creation of charge on this security is less expensive than that of a real estate.

Drawbacks : Inspite of the above advantages, there are certain risks in advancing money against stock exchange securities. The drawbacks are the following :

(i) Partly Paid-up Shares : A share may be partly paid-up, the fact of which is not indicated on the face of it. A partly paid-up share is considered to be a very risky security because :

(a) if the borrower fails to pay the calls, the shares will be forfeited.

(b) the issuing company will generally reserve the right of prior lien over the shares, in respect of the calls money due, by means of its Articles of Association.

(c) there is no market for such shares, since, they will not be quoted in the market.

(d) the banker will have to pay the calls, in case he has already transferred it in his favour.

(e) in other cases, the banker will have to give additional loan so as to enable the borrower to pay the calls. If not, such a share will be forfieted.

(ii) Unquoted Securities : All stock exchange securities are not quoted in the market. If the shares are not quoted, it is very difficult to find out their market value. Moreover, such shares cannot be easily disposed of in the market, since, nobody prefers an unquoted share.

(iii) Risk in Private Company Securities : Generally, the Articles of Association of private companies put a restriction on the transfer of their shares.

(iv) Risk in Forged Transfers : In the case of registered securities, if there is any forgery in the transfer certificate, the banker cannot acquire a good title.

(v) No Guarantee of Income : All companies do not declare a steady dividend. The dividend itself fluctuates depending upon the profit of the company. Some companies do not declare any dividend at all.

(vi) Greater Price Instability : The prices of most of these securities fluctuate violently in the market. There are much upward and downward trends in their prides. It is very difficult to predict their price movements.

(vii) Income Yielding Securities : All these securities earn income in the form of interest and dividend. The greatest advantage is that, these incomes can be appropriated towards the loan amount.

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(iii) Risk in Private Company Securities : Generally, the Articles of Association of private companies put a restriction on the transfer of their shares.

(vii) Bogus Share Certificates : There is a possibility of producing a bogus share certificate and obtain a loan. It is very difficult to distinguish between a genuine one and a bogus one.

(viii) Duplicate Share Certificate : It is also possible to obtain a duplicate share certificate on the ground that the original has been lost. Further, loans can be raised against these duplicate share certificates and, thus double financing is made easier.

Precautions :

The above risks can be reduced, if the following precautions are taken into account :

(i) Nature of the Company : First of all, the banker must study the nature of the business of the issuing company, its past history and future prospects.

(ii) Nature of the Management : The success or failure of any company depends upon its management. Hence, the banker must see whether the management is efficient, competent, capable and experienced.

(iii) Preference to Debentures and Preference Shares : A banker should always prefer debentures and preference shares to equity shares, because, they are safer than ordinary shares. Price fluctuations do not affect the debentures and preference shares.

(iv) Proper Valuation : The banker should not value these securities on the basis of their face values. At the same time, he should not rely completely on their market prices.

(v) Avoid Partly Paid-up Shares : On any account, a banker should not accept partly paid-up shares, because, they are subject to many risks as listed earlier.

(vi) Avoid Unquoted Shares : Similarly, if the shares are not quoted in the market, the banker cannot find out their value. Hence, he should never accept such securities.

(vii) Avoid Private Company Shares : Again, the banker should never accept private companies shares. It is so because, in the event of default of the borrower, he cannot sell them to anybody.

(viii) Avoid Third Party's Securities : It is not advisable to accept shares, standing in the name of third parties as securities for a customers loan. In exceptional cases, the banker can permit it, after getting a letter of Renunciation from the third party stating that he has no objection to give them as securities.

(ix) Avoid Own Shares : As per Sec. 20 of the Banking Regulation Act, 1949, 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.

(x) Preparation of Approved List : A banker cannot advance money blindly against every share offered as security. All the shares do not command the same respect in the market. At the same time, he cannot analyse each and every share as and when it is given as a security. It would be a tedious process. Therefore, the banker prepares a list of securities which could be readily accepted as securities. This list is called 'approved list of securities'. While preparing this list, the banker takes into account the goodwill of the company, nature of its management, marketability of its shares, its dividend paying capacity, acceptable denomination of its shares, its inclusion in the approved list of stock exchanges etc.

(xi) Proper Care in Creation of Charge / Legal Charge : A charge may be created over the securities either by equitable title or by legal title. A legal title is created by means of executing a transfer deed and entering the name of the banker in the books of the company.

17.7 BANKER'S RECEIPT :

Commercial banks have to fulfil many statutory obligations. One such obligation is to maintain the Statutory Liquidity Ratio (SLR). It means that they have to maintain a certain percentage of their deposits in permitted securities. These securities include Government of India securities, State Government bonds and securities of certain other Government agencies like Port Trust, Electricity Companies etc.

In fact, the banking system is not able to cope with the rising volumes of traded securities. Since, a number of banks involve at the same time in security deals to maintain SLR, physical delivery of securities and bonds immediately after the conclusion of the deal has been almost an impossibility.

Meaning :

A BR is a statement issued by a selling bank to a buying bank declaring that it has received payment for certain securities already in its custody and promising to deliver them within a certain period.

SGL Notes : As per the RBI guidelines, BRs could be issued only in the case of trading in State Government bonds and issues of various Government agencies. As regards the Central Government securities, the RBI has the exclusive possession.

Risks Associated with BRs :

(i) Issue of Fake BRs : A BR is always issued against the backing of sufficient securities. It is possible that a BR may be issued by a selling bank without holding the necessary securities to back the BR. In such a case, the BR is called a Fake BR and it is a fraudulent one.

(ii) Non-negotiable Document : A BR is a non-negotiable instrument. Hence, the buying bank cannot acquire any better title than that of the selling bank. Moreover, a buying bank cannot endorse the BR to some other bank nor can it issue a fresh BR against an old one.

(iii) BR in Favour of Brokers : A BR transaction is between one bank to another bank only. But, sometimes, there is a possibility to issue BRs in favour of brokers also.

(iv) Issue of BRs Instead of SGL Notes : Sometimes, a BR may be issued in respect of trading in Central Government securities. It is against the guidelines of the RBI and such a BR is not recognised.

Precautions :

(i) Genuine BRs : Generally, BRs are issued on mutual trust and confidence. However, the buying bank should ensure that the BR has been issued against the backing of adequate securities.

(ii) Related to State Government Bonds : The banker must also see whether the BR has been issued against State Government bonds and securities of other Government agencies.

(iii) BR not Routed Through a Third Bank : A BR is a non-negotiable security. Hence, a BR transaction should be from one bank to another. If it is routed through a third bank, it should not be preferred.

(iv) Period of BR : The banker should pay attention to the period of the BR.

(v) Prescribed Format : The banker should also note whether the BR has been issued in the prescribed format.

17.8 SUPPLY BILLS :

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 gets an order for the supply of goods. Similarly, the government contract work is given to contractors by inviting tenders.

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.

Risks in Advances Against Supply Bills :

(i) Clean Advance : Advances against supply bills are virtually clean advances. The supply bills are not accompanied by documents of title to goods. The security available to a banker is by way of assignment of debts represented by supply bills.

(ii) Delayed Payment : The payment for the bills may be delayed on 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 on the 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 business 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.

(iii) Power of Attorney : The banker should get an irrevocable power of attorney executed by the borrower in his favour authorising him to collect the bills in respect of supplies referred thereto.

(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) Bills to be Receipted : The supply bills should be receipted by the bank on a revenue stamp.

(vi) Nature of Bills : There are two types of bills : (i) Interim bill against which the government pays 80% to 85% of the value of goods despatched. (ii) Final bill for the remaining 15% to 20% of the value of goods supplied. Usually the interim bills for 80% to 85% of the value of goods are submitted for the loan.

(vii) Adequate Margin : The banker should keep adequate margin while advancing against supply bills. Usually 10% to 25% margin is maintained.

(viii) Departments : The bills should be forwarded to the respective departments for payment together with a covering letter stating 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.

(ix) Follow-up : The banker should keep a watch on payment of supply bills.

TYPES OF SECURITIES

17.9 LAND AND BUILDINGS AS SECURITY (Real Estate) :

Bankers do not generally lend against land and buildings or against securities relating there to. The reasons are :

1. Legal Title : It is very difficult to satisfy oneself with regard to the ownership of property. The banker is likely to land himself in litigation if he disposes of the security to recover his money. The law relating to succession and transfer of immovable property is very complicated and the banker will be courting trouble if he accepts land as security.

2. Valuation Difficulty : The valuation of land and buildings is very difficult. Several factors will have to be taken into account when valuing property.

3. Difficulty in Selling : It is very difficult to sell property. It may be valuable in itself, but when put up for sale, it may fetch much less than its real value. For this reason, if a banker lends against land and buildings, he will be locking up his funds.

4. Expenses : The expenses for effecting the legal mortgage are heavy.

5. Legal Hurdles : In some States, restrictions are imposed on the transfer of property in the land. For instance, the Punjab Land Alienation Act forbids the transfer of land to non-cultivators.

Precautions : If, however, the banker decides to lend against land, he must take the following precautions :

1. He must satisfy himself with regard to the title of the property.
2. He should obtain legal advice before granting the loan.
3. He must take a legal mortgage. The deed should be registered.
4. He should obtain a non-encumbrance certificate from the Registrar’s office.

Legal and Equitable Mortgage : A mortgage is defined by Section 58 of the Transfer of Property Act as ‘the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”.

Legal mortgage is the transfer by deed of the legal estate in land subject to the mortgage for the payment of money due or to become due to the person who takes the security.

As between two equitable mortgages, a prior mortgage takes precedence over a subsequent one. Similarly, as between two legal mortgages, a prior mortgage takes precedence over a subsequent mortgage.

(a) Agricultural Lands : These are not suitable securities as cover for a Bank’s advances. The amounts advanced against such securities are comparatively small. They are not very popular with the bankers for the following reasons :

1. Legal Hindrances : There are legal or customary hindrances to their transfer. Some checks are imposed by legal enactments *e.g.* Deccan Agriculturists Act, Bombay, and Hindu and Mohammadan Laws.

2. Legal Mortgage Very Expensive : In mortgaging lands, heavy expenses are to be incurred by the customer. The customer may find it difficult to meet them.

3. Difficulties Regarding Customer's Title : This is an important reason. It becomes very difficult to find out the title of the customer. The law relating to this subject is very complicated.

4. Security Rigid : It is very difficult to realise lands. Hence the banker cannot think of locating up his capital for a long time. This is particularly a disadvantage to commercial banks, which depend mostly on current deposits.

5. Changing Land Tenures : A banker should note the land tenures in the States, their changes and the incidents attached to them. The value of land depends upon the land tenure.

6. Problems in Valuation : There is difficulty in valuation of land. The banker has to depend upon valuations reports of expert Surveyors and Engineers for deciding margin, depreciation and other factors.

7. Legal Formalities for Selling the Mortgaged Land : There will be delay in realisation of security when the mortgagor, fails to pay the amount. This is due to several legal formalities.

(b) Building Standing on a Lease-Hold Land where the Lease is to Expire Shortly : Generally it is not safe for a banker to give advances on the security of immovable properties such as Land, Building etc. Hence he must be very cautions.

Before advancing money against such assets, the banker should note the terms of the lease very carefully, particularly about transfer and underleasing. Some leases insist on prior permission of the lessor for transfer.

Reasons for the Wider Acceptance of Goods as Security :

1. Easy to Sell : Goods are easy to sell. They can more easily be sold than certain other forms of security such as land and buildings.

2. Small Fluctuations in Prices : In the case of goods which are necessaries of life the risk of fluctuations in prices is small.

3. Value Ascertainable : The value of goods can more easily be ascertained. Wholesale prices are published regularly in newspapers and are broadcast over the radio.

4.Short Period Loans : Usually advance against goods are for short periods on account of their seasonal character. These advances may be renewed after the period of the loan.

Risks : But this kind of security has the following drawbacks.

1. Deterioration in Quality/Weight : Goods or produce stored for considerable periods are liable to deteriorate, or lose in weight. All the goods may not be durable goods.

2. Risks of Fraud : There are the risks of fraud. For instance if an advance is secured by bags of paddy, not all the bags may contain paddy. Some of them may be filled up with husk.

3. Difficulty in Valuation : Valuation is difficult unless the banker possesses considerable experience. It may be difficult to differentiate between different varieties of the commodity.

4. Price Fluctuations : Some kinds of produce are subject to great fluctuations in prices. In the present context when prices are rising almost every month, the danger may not be great.

5. Difficulty in Selling : It may be difficult to dispose of large quantities of produce at a single place. The costs of transport to other places may be prohibitive.

6. Absence of Warehouses : Absence of public ware-houses is another difficulty. Private godowns do not possess equal security and there is the danger of the goods being removed after being given as security.

1. Precautions : The banker must make sure that the borrower is honest and thoroughly reliable. The banker has to rely on his past experience to judge the creditworthiness of the customer.

2. The banker must see the purpose of the loan. He can safely lend where the stocks have been acquired for preparing them for the market, for instance husking paddy or ginning cotton.

3. The banker must examine whether the commodity commands a good market, whether its prices are liable to wide fluctuations.

4. The banker must see that the storage conditions of the commodity offered as security are adequate and proper. He should keep a godown register and note all particulars in it.

Goods offered for security must be stored in proper godowns. Godowns must be well protected against fire, floods, theft etc.

In the case of hypothecation of goods, the borrower should give an undertaking that he will allow inspection of godown and stock register as and when desired.

5. The banker must be well acquinted with the type of goods accepted as security. Also he must be acquinted with the market conditions for such commodities.

6. The banker must be careful in valuing the goods. He should satisfy himself both as to quantity and price. For this he should acquire sufficient experience in the kind of goods that are usually offered as security.

17.10 ADVANCES AGAINST LIFE POLICIES :

A life insurance contract is one by which the insurer (the insurance company) in consideration of a certain premiums payable in a number of instalments undertakes to pay to the person for whose benefit the insurance is made, a certain sum of money on the expiry of a certain period or on the death of the insured, whichever is earlier. A life insurance policy may be a whole life policy, in which case the premia are payable throughout the life of the assured. It may be an endowment policy, in which case premia are payable for a stated number of years or until the death of the insured, whichever is earlier. The Life Insurance Corporation of India, enjoyed monopoly of life insurance business in India till recently. Now the business is open to private sector companies. A good number of life insurance companies with the foreign collaboration have come into existence. There is Life Insurance Regulatory Authority which regulates the activities of companies doing life insurance business.

A life insurance contract is a contract *of uberrimae fidei, i.e.,* of utmost good faith. The insured must disclose all material facts within his knowledge relating to his life.

In a contract of insurance, the law requires the existence of insurable interest to support it. In this, it differs from a contract of wager, in which there need be no insurable interest. Insurable interest means that the person effecting insurance will sustain a pecuniary loss on the death of the person whose life is insured.

Types of Policies :

The important life insurance policies are as follows :

1. Whole-Life Policy : The policy-holder will have to pay premiums till death. The insured amount will be paid after death to the nominee.

2. Endowment Policy : Under this type of policy the insured person will pay premium till the attainment of a specified age or for the specified period or till death if it occurs earlier. If the assured survives till the completion of the period, the assured sum will be paid to him. In the event of death occuring earlier, the amount will be paid to the nominees.

The policies may be with profits or without profits. In the case of policies with profits, bonus will be declared at periodical intervals out of profits made by the company and on maturity of the policy, the insured amount plus bonus will be paid. Bonus or profit claused may be added to life and endowment policies. By collecting additional premium, accident benefit will also be extended.

Merits of Insurance Policies as Banker's Security :

1. An insurance policy is remarkably free from the risk of a fall in value. In fact, with the successive payments of premia, its value goes on increasing.

2. It is very easy to take an insurance policy as security because the legal formalities to be fulfilled are few.

3. The policy can be assigned in favour of the banker. When the policy is assigned in favour of the banker, he is entitled to receive the sum insured when the policy matures or in case of death of the borrower, should that takes place earlier.

Risks :

1. The policy will be alive only so long as premia are regularly paid. Otherwise the policy

will lapse.

2. The law relating to assignments of insurance policies is unsatisfactory in India. Priority is governed by the date of assignment and not by the date of registration at the com pany.
3. Since an insurance contract is a contract of *uberrimae fidei*, the insurance company may seek to repudiate the contract on the ground that a material fact had not been disclosed.
4. The insurance company need not pay if the insured commits suicide.
5. If the insurance policy is taken for the express benefit of the wife and children of the insured, the banker will not have any claim on the policy if there are minor children.
6. Sometimes the insured may obtain a duplicate copy of the insurance policy with a view to creating a charge on it.

Precaution to be taken by Banker :

1. The banker must ascertain whether the policy is alive or not. He should examine the latest premium receipt. He should take a declaration from the customer that the latter will pay future premia regularly. As a measure of precautions, he should also take a standing orderfrom the customer to pay future premia and debit it this account.
2. The banker should take care not to lend more than the surrender value of the policy. He should also keep proper margin to provide for the accrual of interest.
3. He should prefer endowment policies to life policies, because the number of premiums in the former are fixed.
4. The banker must make sure that there is insurable interest because in its absence the insurance amount does not become payable.
5. He should take special precautions regarding the conditions of assignment. Sometimes, insurance policies contain conditions against assignments. He should ensure that there are no previous assignments and should ask for a letter to that effect from the borrower. He should take a legal assignment of the policy and not merely an equitable assignment.
6. The banker should see that the age of the assured has been admitted by the company with reference to the school register, or an extract from the register of births and deaths or horoscope of the customer.

17.11 SUMMARY :

Generally banks advance money against tangible securities. Collateral securities, in a broad sense, refer to all those securities deposited by a customer to secure a loan.

17.12 SELF ASSESSMENT QUESTIONS :

Five Marks Questions :

1. Secured Loans
2. Bill of lading
3. Railway Receipt.
4. Documents to title to goods.
5. Warehouse receipt.

Ten Marks Questions :

1. What precautions should a banker take while advancing loans on supply bills ?
2. State the precautions taken by a bank while granting loans against fixed deposit receipts.

Twenty Marks Questions :

1. Explain the various considerations that a banker should take while lending.
2. What are collateral securities ? What precautions does a banker take in loans against (a) Real estate (b) Stock exchange securities ?
3. What precautions should a banker take while advancing loans against life insurance policies and stock exchange securities.
4. What precautions should a banker take while advancing loans against documents to title to goods ?
5. What precautions should a banker take while making advances against warehouse receipts and bill of lading ?

17.13 BOOKS RECOMMENDED :

1. Sundharam & Varsheney	:	Banking theory Law & practice
2. Tannin’s Banking	:	Law and Practice in India.
3. Maheswari and Paul R.R	:	Banking Theory and Law & Practice.
4. Dr. K.N.Prasad and T.Chandradass	:	Banking and Financial System
5. Ruddar Datt and K.P.M. Sundaram	:	Indian Economy.

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