BA4003 BANKING AND FINANCIAL SERVICES

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COURSE OBJECTIVES:

- Grasp how banks raise their sources and how they deploy it and manage the associated risks
- Understand e-banking and the threats that go with it.
- Understand about other asset based and fund based financial services in India

UNITI INTRODUCTION TO INDIAN BANKING SYSTEM AND PERFORMANCE EVALUATION 9

Overview of Indian Banking system - Structure - Functions - Key Regulations in Indian Banking sector -RBI Act, 1934/ 2006 -Banking Regulation Act, 1949- Negotiable Instruments Act 1881/2002- Provisions Relating to CRR- Provision for NPA's-Overview of Financial Statements of banks- Balance Sheet- Income Statement- CAMEL

UNITII MANAGING BANK FUNDS/ PRODUCTS & RISK MANAGEMENT 9

Capital Adequacy - Deposit and Non-deposit sources - Designing deposit schemes and pricing of deposit sources - loan management - Investment Management - Asset and Liability Management - Financial Distress -Signal to borrowers - Prediction Models - Risk Management – Interest rate – Forex – Credit market -operational and solvency risks –NPA's-Current issues on NPA's- M&A's of banks in to securities market

UNITIII DEVELOPMENT IN BANKING TECHNOLOGY 9

Payment system in India - paper based - e payment - electronic banking -plastic money - e-money-forecasting of cash demand at ATM's-The Information Technology Act,2000 in India-RBI's Financial Sector Technology vision document- security threats in e-banking &RBI' Initiative.

UNITIV ASSET BASED FINANCIAL SERVICES 9

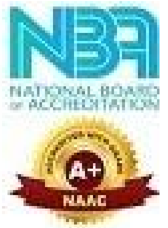
Introduction-NeedforFinancialServices-FinancialServicesMarketinIndia-NBFC-RBIframework and act for NBFC – Leasing and Hire Purchase – Financial evaluation –underwriting–mutual funds

UNITV INSURANCE AND OTHER FEE BASED FINANCIALSERVICES 9

Insurance Act, 1938 - IRDA – Regulations – Products and services - Venture Capital Financing- Bill discounting- factoring-Merchant Banking-Role of SEBI

TOTAL: 45 PERIODS

PROGRESS THROUGH KNOWLEDGE



1. Understand the overall structure and functions of Indian Financial System
2. Gain knowledge about regulations governing the Indian Banking system
3. Price various types of loans proposed by banks to various prospective borrowers with different risk profiles and evaluate the performance of banks
4. Familiar is the students with the concept of e-banking
5. In-depth understanding of fee-based and fund-based financial services in India

REFERENCES:

1. Padmalatha Suresh and Justin Paul, "Management of Banking and Financial Services, Pearson, Delhi, 2017.
2. Meera Sharma, "Management of Financial Institutions- with emphasis on Bank and Risk Management", PHI Learning Pvt.Ltd., New Delhi2010
3. Peter S. Rose and Sylvia C. and Hudgins, "Bank Management and Financial Services", Tata McGraw Hill, NewDelhi, 2017

UNIT: 1

INTRODUCTION TO INDIAN BANKING SYSTEM AND PERFORMANCE EVALUATION

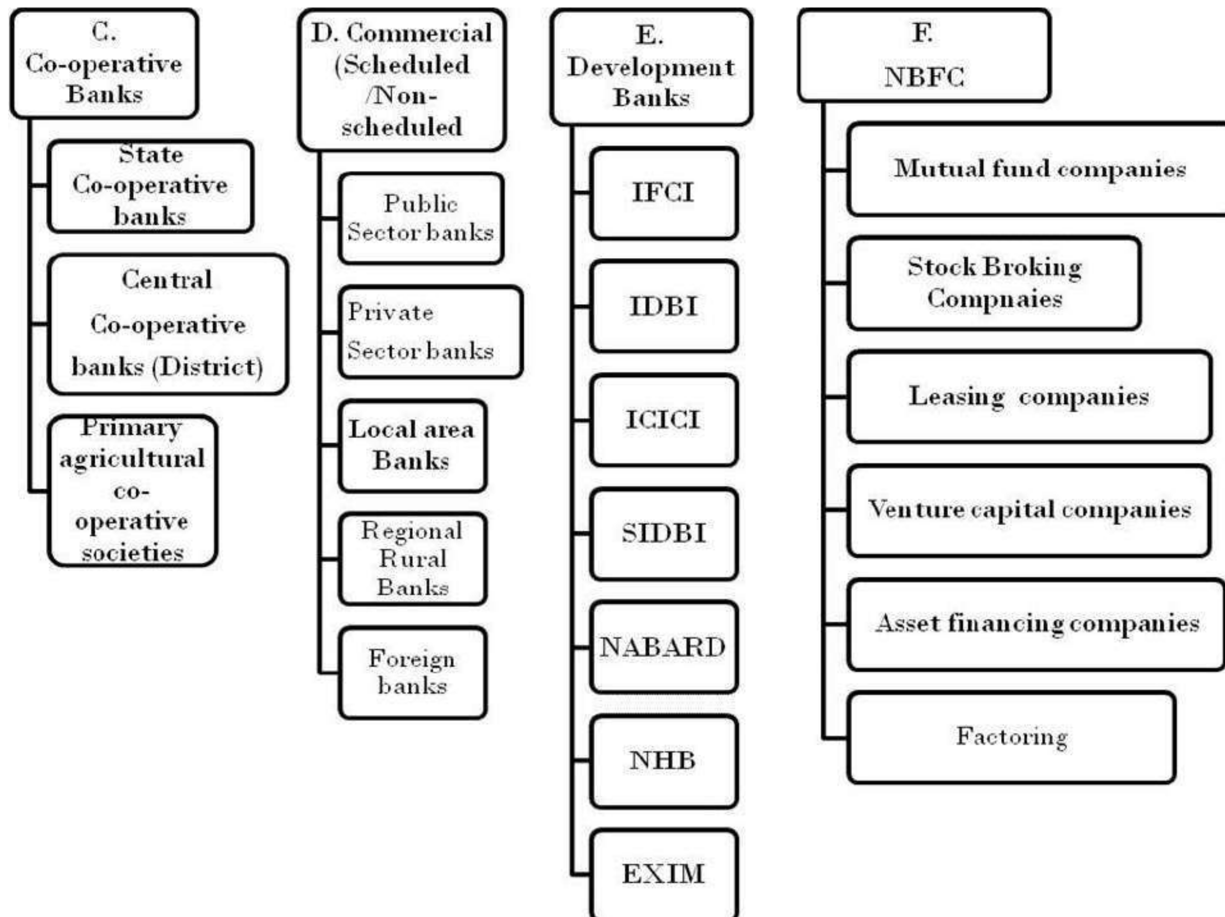
Genesis

A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. A major landmark in Indian banking history took place in 1934 when a decision was taken to establish 'Reserve Bank of India' which started functioning in 1935. Since then, RBI, as a central bank of the country, has been regulating banking system.

INDIAN BANKING SYSTEM

A .Reserve Bank of India

B. State Bank of India and its Associate (Subsidiaries) Banks



A. Reserve Bank of India as a Central Bank of the Country

The Reserve Bank, as the central bank of the country, started their operations as a private shareholder's bank. RBI replaced the Imperial Bank of India and started issuing the currency notes and acting as the banker to the government. Imperial Bank of India was allowed to act as the agent of the RBI. RBI covered all over the undivided India. In order to have close integration between policies of the Reserve Bank and those of the Government, It was decided to nationalize the Reserve Bank immediately after the independence of the country.

From 1st January 1949, the Reserve Bank began functioning as a State owned and State-controlled Central Bank.. To streamline the functioning of commercial banks, the Government of India enacted the Banking Companies Act, 1949 which was later changed as the Banking Regulation Act 1949. RBI acts as a regulator of banks, banker to the Government and banker's bank. It controls financial system in the country through various measures.

B. State Bank of India and its Associate (Subsidiaries) Banks - A New Channel of Rural Credit

An act was passed in Parliament in May 1955 and the State Bank of India was constituted on 1 July 1955. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959, enabling the State Bank of India to take over eight former State-associated banks as its subsidiaries (later named Associates). Associate Banks of State Bank of India viz.,

i. State Bank of Hyderabad,
ii. State Bank of Mysore,
iii. State Bank of Bikaner and Jaipur,
iv. State Bank of Travancore,
v. State Bank of Patiala,
vi. State Bank of Indore,
vii. State Bank of Saurashtra

Nationalization of Banks for implementing Govt. policies

Indian Banking System witnessed a major revolution in the year 1969 when 14 major commercial banks in the private sector were nationalized on 19th July, 1969. Most of these banks having deposits of above 50 crores were promoted in the past by the industrialists. These banks were:

1. Allahabad Bank
2. Bank of Baroda
3. Bank of India

4. Bank of Maharashtra
5. Canara Bank
6. Central Bank of India
7. Dena Bank
8. Indian Bank
9. Indian Overseas Bank
10. Punjab National Bank
11. Syndicate Bank
12. Union Bank of India
13. United Bank of India
14. United Commercial Bank (now known as UCO bank)

The purpose of nationalization was:

(a) To increase the presence of banks across the nation.
(b) To provide banking services to different segments of the Society.
(c) To change the concept of class banking into mass banking, and
(d) To support priority sector lending and growth.

In 1980, another six more commercial banks with deposits of above ` 200 crores were nationalized:

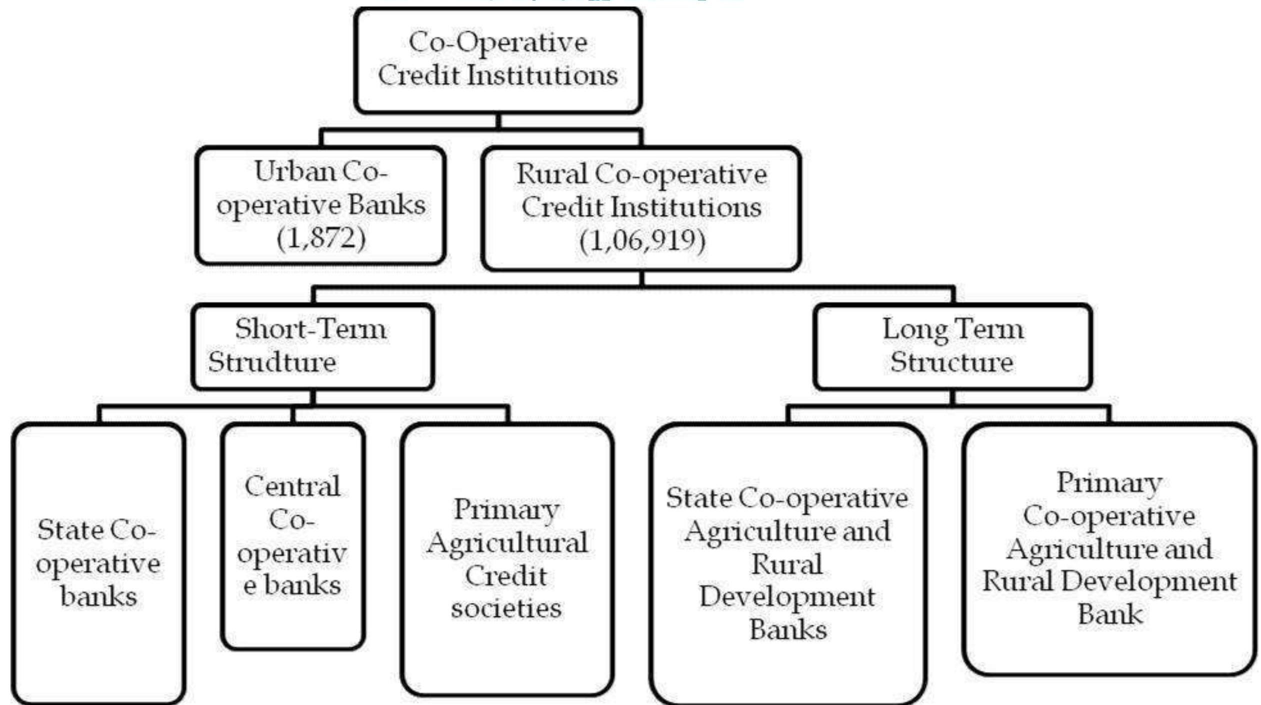
1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Punjab and Sind Bank
5. Oriental Bank of Commerce
6. Vijaya Bank

C. Co-Operative Banking System

Co-operative bank was set up by passing a co-operative act in 1904. They are organized and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operative banks generally provide their members with a wide range of banking and financial services (loans, deposits, banking accounts...).

Co-operative Banks have a three-tier set-up with the state co-operative bank at the apex, the district co-operative bank at the district level and the primary credit societies at the village level.



D. Commercial Banks

Commercial bank is an institution that accepts deposit, makes business loans and offer related services to various like accepting deposits and lending loans and advances to general customers and business man.

A commercial bank is a financial institution that is authorized by law to receive money from businesses and individuals and lend money to them. Commercial banks are open to the public and serve individuals, institutions and businesses. A commercial bank is almost certainly the type of bank you think of when you think about a bank because it is the type of bank that most people regularly use.

i. Scheduled Banks

A scheduled bank is a bank that is listed under the second schedule of the RBI Act, 1934. In order to be included under this schedule of the RBI Act, banks have to fulfill certain conditions such as having a ***paid up capital and reserves of at least 0.5 million*** and satisfying the Reserve Bank that its affairs are not being conducted in a manner prejudicial to the interests of its depositors.

Scheduled banks are further classified into commercial and cooperative banks. The basic difference between scheduled commercial banks and scheduled cooperative banks is in their holding pattern.

Scheduled cooperative banks are cooperative credit institutions that are registered under the Cooperative Societies Act. These banks work according to the cooperative principles of mutual assistance.

ii. Non- scheduled banks

Non-scheduled banks also function in the Indian banking space, in the form of Local Area Banks (LAB) with the purpose of developing backward and less developed districts. As at end-March 2011 there were only 4 LABs operating in India. In order to facilitate its formation, RBI prescribed a minimum capital of Rs.500 lakhs for its formation by Individuals/Trusts/Societies/Corporates. The contribution towards capital of a LAB by a single family should not exceed 40% of the total paid up capital.

iii. Public Sector Banks

At the end of march 2013, there were 27 public sector banks in India, comprising of state bank of India and its associate banks(6), and 20 nationalized banks (including IDBI bank Ltd).

It includes SBI, seven (7) associate banks and nineteen (19) Nationalized banks. Altogether there are 27 public sector banks. The public sector accounts for 90 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks

The public sector banks in India are regulated by statutes of the parliament and some important provisions under section 51 of the banking regulation Act, 1949.

Specially, the regulations are as follows;

- State bank of India regulated by the state bank of India Act, 1955.
- Subsidiary banks of SBI regulated by SBI(Subsidiary banks) Act,1959.
- Nationalized banks regulated by banking companies(Acquisition and transfer of undertakings) Act,1970 and 1980.

iv. Private Sector Banks

Private sector banks are those whose equity is held by private shareholders. For example, ICICI, HDFC etc. Private sector bank plays a major role in the development of Indian banking industry.

At the end of march 2013, there were 20 private sector banks in India, of which 13 are classified as ‘old’ and the remaining 7 as are classified as ‘new’ private sector banks.

The broad underlying principle in permitting the private sector to own and operate banks is to ensure that ownership and control is well- diversified and sound corporate governance principles are observed.

New private sector banks can initially enter the market with a capital of Rs. 200 crores, which should be increased to Rs.300crores over the following three years. No single entity or group can have shareholding or control more than 10% of paid-up equity capital of the bank. The aggregate foreign investment in an Indian private sector bank cannot exceed 74% and at least 26% of the paid-up capital should be held by Indian Resident.

v. Foreign Banks

Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India.

Foreign banks are required to invest an assigned capital of USD 25 million upfront at the time of opening their first branch in India.

They can operate in India in one of the following three ways;

1) Through branches,
2) Through wholly – owned subsidiaries, and
3) Through subsidiaries with maximum foreign investment of 74 % in a private sector bank.

Hence, foreign banks can have an assets share, equity stake and FII investment in the Indian banking system.

vi. Regional Rural banks

In 1975, a new set of banks called the Regional Rural Banks, were setup based on the recommendations of a working group headed by Shri.Narasimham, to serve the rural population in addition to the banking services offered by the co-operative banks and commercial banks in rural areas. Inception of regional rural banks (RRBs) can be seen as a unique experiment as well as experience in improving the efficacy of rural credit delivery mechanism in India. With joint shareholding by Central Government, the concerned State Government and the sponsoring bank, an effort was made to integrate commercial banking within the broad policy thrust towards social banking keeping in view the local peculiarities.

These are state sponsored regional rural oriented banks. They provide credit for agricultural and rural development. The main objective of RRB is to develop rural economy. Their borrowers include small and marginal farmers, agricultural labourers, artisans etc.

The RRBs were created for rural credit delivery and to ensure financial inclusion. Their capital base is held by the Central government, relevant State government and the Commercial bank that ‘sponsor’ them, in the ratio of 50:15:35, respectively.

E. Development Banks

Development banks are financial institutions established to lend (loan) finance (money) on subsidized interest rate. Such lending is sanctioned to promote and develop important sectors like agriculture, industry, import-export, housing and allied activities.

i. Industrial Finance Corporation of India (IFCI)

At the time of Independence in 1947, India’s capital market was relatively under-

developed and the commercial banks were not equipped to provide long-term industrial finance in any significant manner.

Our Government established the Industrial Finance Corporation of India (IFCI) on July 1, 1948 as the First Development Financial Institution in the Country fulfills the long-term finance needs of the industrial sector. The following sectors that have directly benefited from IFCI:

a. Consumer goods industry (textile, Paper, sugar, etc.)
b. Service industries (Hotels, Hospitals, etc.,)
c. Basic Industries (Iron & Steel, Fertilizers, Basic Chemicals, Cement)
d. Capital and Intermediate Goods industries (Electronics, Synthetic Fibers, Synthetic plastics)
e. Infrastructure (power generation, telecom services)

ii. Industrial Development bank of India (IDBI)

It is India's premier Development Financial Institution and the 10th largest development bank of the world. It was established on 1.7.1964 as a wholly owned subsidiary of RBI, and then its ownership transferred to Govt. of India on 16.2.1976 with 72% of shares. It provided wide range of promotional activities, entrepreneurship development, self-employment, consultancy and advisory services to small entrepreneurs, etc.

iii. Industrial Credit Investment Corporation of India (ICICI)

ICICI was established by the Govt. of India in the 1960s as a Financial Institution with the objective to finance large industrial projects. During 1990, it is founded a separate legal entity as ICICI Bank to do normal banking operations – taking deposits, credit cards , car loans etc. It was the first bank offered a wide network of ATM's till 2005, before SBI caught up with it.

iv. Small Industries Development Bank of India (SIDBI)

It was established under SIDBI Act 1988 on 2.04.1990, as a subsidiary of IDBI taking over the latter's activities relating to SSI. Its aim is to financing and development of industry in the small scale sector (Investment not exceeding Rs.10 million). In addition SIDBI assists, transport, health care, hotel and tourism sectors, infrastructure, etc.

v. National Bank for Agriculture and Rural Development (NABARD)

It is established on 12.07.1982 as an apex bank for agriculture and rural development.

Objectives of NABARD

a. Credit Dispensation – Preparation of district level credit plans annually for agricultural and allied activities.
b. Developmental & Promotional – Dissemination of innovative products and services, Promotion of rural non-farm sectors, consultancy services, supporting R&D.
c. A Supervisory Activities – Conducting periodic inspections of State level co-operative institutions.

vi. National Housing Bank (NHB)

It was established on 9.7.1998 as wholly owned subsidiary of RBI. The major aim is to promote housing finance institutions and to provide financial and other support to such institutions. It formulates schemes for the purpose of mobilization of resources and extension of credit for housing.

vii. Export Import Bank Of India (EXIM)

Setup on September 1981, and commenced its operation in March 1982. It is the principal financial institution in the country for co-coordinating working of institutions engaged in financing exports and imports.

Other financial supports and programmes:

a. Lending programme for Export oriented units
b. Production equipment finance programmes
c. Import finance
d. Export marking finance
e. Performance guarantee
f. Advance payment guarantee
g. Guarantee for raising borrowing overseas
h. Foreign currency pre-shipment credit, etc.

F. Non-Banking Financial Companies

A Non-Banking Financial Company (NBFC) is a company a) registered under the Companies Act, 1956, b) its principal business is lending, investments in various types of shares/stocks/bonds/debentures/securities, leasing, hire-purchase, insurance business, chit business, and c) its principal business is receiving deposits under any scheme or arrangement in one lump sum or in installments.

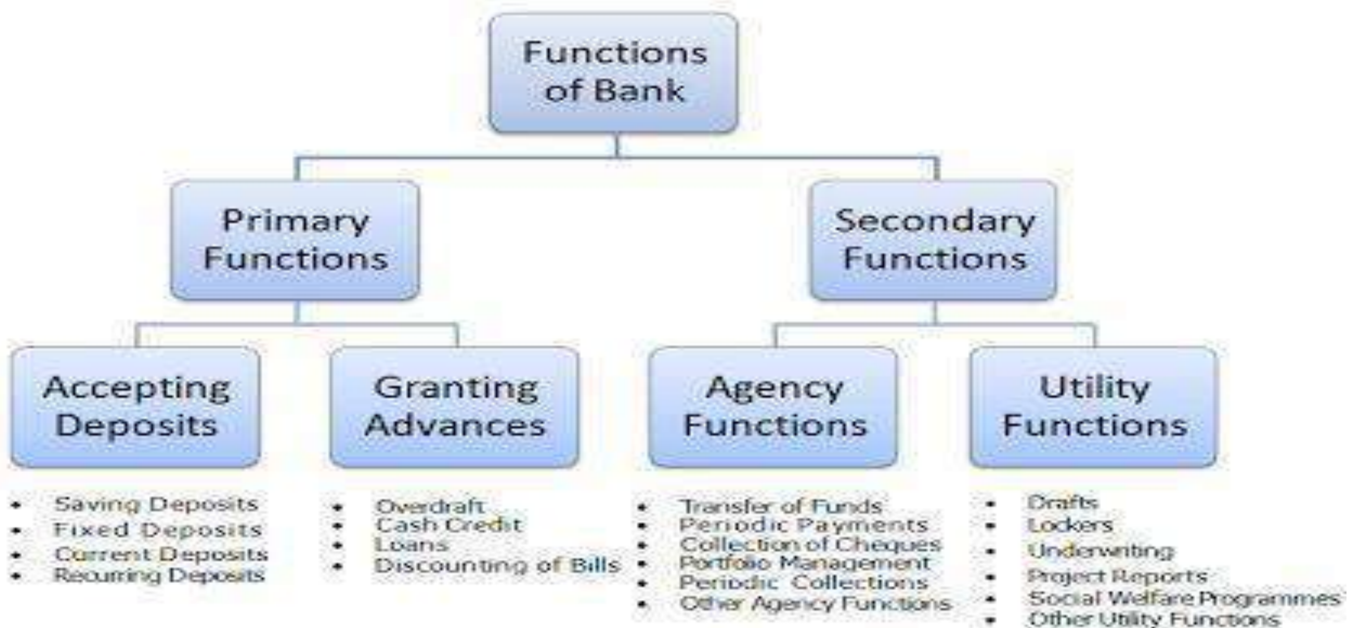
However, a Non-Banking Financial Company does not include any institution whose principal business is agricultural activity, industrial activity, trading activity or sale/purchase/construction of immovable property.

a. **Mutual fund companies: Mutual Fund**. A **mutual fund** is a **company** that brings together money from many people and invests it in stocks, bonds or other assets. The combined holdings of stocks, bonds or other assets the **fund** owns are known as its portfolio.

b. **Stock Broking Companies:** A **stockbroker** is a regulated professional individual, usually associated with a brokerage firm or **broker**-dealer, who buys and sells **stocks** and other securities for both retail and institutional clients, through a **stock** exchange or over the counter, in return for a fee or commission.
c. **Leasing companies:** The **leasing company** is the legal owner of the goods, but ownership is effectively conveyed to the lessee, who incurs all benefits, costs, and risks associated with ownership of the assets.
d. **Venture capital Company:** An investor who either provides **capital** to startup **ventures** or supports small **companies** that wish to expand but do not have access to public funding.
e. **Asset financing companies:** '**Asset Financing**' Using balance sheet **assets** (such as accounts receivable, short-term investments or inventory) to obtain a loan or borrow money - the borrower provides a security interest in the **assets** to the lender.

   An AFC is a *company* which is a *financial* institution carrying on as its principal business the *financing* of physical *assets* supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments
f. **Factoring:** 'Factor' A financial intermediary that purchases receivables from a company. A factor is essentially a funding source that agrees to pay the company the value of the invoice less a discount for commission and fees.

FUNCTIONS OF BANKS



A. Primary Functions of Banks

The primary functions of a bank are also known as banking functions. They are the main functions of a bank.

These primary functions of banks are explained below.

1. Accepting Deposits

The bank collects deposits from the public. These deposits can be of different types, such as:-

- Saving Deposits
- Fixed Deposits
- Current Deposits
- Recurring Deposits

a. Saving Deposits

This type of deposits encourages saving habit among the public. The rate of interest is low. At present it is about 5% p.a. Withdrawals of deposits are allowed subject to certain restrictions. This account is suitable to salary and wage earners. This account can be opened in single name or in joint names.

b. Fixed Deposits

Lump sum amount is deposited at one time for a specific period. Higher rate of interest is paid, which varies with the period of deposit. Withdrawals are not allowed before the expiry of the period. Those who have surplus funds go for fixed deposit.

c. Current Deposits

This type of account is operated by businessmen. Withdrawals are freely allowed. No interest is paid. In fact, there are service charges. The account holders can get the benefit of overdraft facility.

d. Recurring Deposits

This type of account is operated by salaried persons and petty traders. A certain sum of money is periodically deposited into the bank. Withdrawals are permitted only after the expiry of certain period. A higher rate of interest is paid.

2. Granting of Loans and Advances

The bank advances loans to the business community and other members of the public. The rate charged is higher than what it pays on deposits. The difference in the interest rates (lending rate and the deposit rate) is its profit.

The types of bank loans and advances are:-

- Overdraft
- Cash Credits
- Loans
- Discounting of Bill of Exchange

a. Overdraft

This type of advances is given to current account holders. No separate account is maintained. All entries are made in the current account. A certain amount is sanctioned as overdraft which can be withdrawn within a certain period of time say three months or so. Interest is charged on actual amount withdrawn. An overdraft facility is granted against a collateral security. It is sanctioned to businessman and firms.

b. Cash Credits

The client is allowed cash credit upto a specific limit fixed in advance. It can be given to current account holders as well as to others who do not have an account with bank. Separate cash credit account is maintained. Interest is charged on the amount withdrawn in excess of limit. The cash credit is given against the security of tangible assets and / or guarantees. The advance is given for a longer period and a larger amount of loan is sanctioned than that of overdraft.

c. Loans

It is normally for short term say a period of one year or medium term say a period of five years. Now-a-days, banks do lend money for long term. Repayment of money can be in the form of installments spread over a period of time or in a lump sum amount. Interest is charged on the actual amount sanctioned, whether withdrawn or not. The rate of interest may be slightly lower than what is charged on overdrafts and cash credits. Loans are normally secured against tangible assets of the company.

d. Discounting of bill of exchange

The bank can advance money by discounting or by purchasing bills of exchange both domestic and foreign bills. The bank pays the bill amount to the drawer or the beneficiary of the bill by deducting usual discount charges. On maturity, the bill is presented to the drawee or acceptor of the bill and the amount is collected.

B. Secondary Functions of Banks

The bank performs a number of secondary functions, also called as non-banking functions.

These important secondary functions of banks are explained below.

1. Agency Functions

The bank acts as an agent of its customers. The bank performs a number of agency functions which includes:-

- Transfer of Funds
- Collection of Cheques
- Periodic Payments

- Portfolio Management
- Periodic Collections
- Other Agency Functions

a. Transfer of Funds

The bank transfer funds from one branch to another or from one place to another.

b. Collection of Cheques

The bank collects the money of the Cheques through clearing section of its customers. The bank also collects money of the bills of exchange.

c. Periodic Payments

On standing instructions of the client, the bank makes periodic payments in respect of electricity bills, rent, etc.

d. Portfolio Management

The banks also undertake to purchase and sell the shares and debentures on behalf of the clients and accordingly debits or credits the account. This facility is called portfolio management.

e. Periodic Collections

The bank collects salary, pension, dividend and such other periodic collections on behalf of the client.

f. Other Agency Functions

They act as trustees, executors, advisers and administrators on behalf of its clients. They act as representatives of clients to deal with other banks and institutions.

2. General Utility Functions

The bank also performs general utility functions, such as :-

- Issue of Drafts, Letter of Credits, etc.
- Locker Facility
- Underwriting of Shares
- Dealing in Foreign Exchange
- Project Reports
- Social Welfare Programmes
- Other Utility Functions

a. Issue of Drafts and Letter of Credits: Banks issue drafts for transferring money from one place to another. It also issues letter of credit, especially in case of, import trade. It also issues travellers' cheques.

b. Locker Facility: The bank provides a locker facility for the safe custody of valuable documents, gold ornaments and other valuables.

c. Underwriting of Shares: The bank underwrites shares and debentures through its merchant banking division.

d. Dealing in Foreign Exchange: The commercial banks are allowed by RBI to deal in foreign exchange.

e. Project Reports: The bank may also undertake to prepare project reports on behalf of its clients.

f. Social Welfare Programmes: It undertakes social welfare programs, such as adult literacy programs, public welfare campaigns, etc.

g. Other Utility Functions: It acts as a referee to financial standing of customers. It collects creditworthiness information about clients of its customers. It provides market information to its customers, etc. It provides travellers' Cheque facility.

ACTS GOVERNING THE FUNCTIONS OF INDIAN BANKING SYSTEM

A. **Reserve Bank of India Act, 1934**
B. **Banking Regulation Act, 1949**
C. **Negotiable Instruments act 1881**

A. RESERVE BANK OF INDIA ACT, 1934

The Reserve bank was established on April 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934, with its central office at Mumbai since inception.

The preamble of the act prescribes the objective of the Reserve Bank as follows:

'....to regulate the issue of bank notes and keeping of reserve with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

The Reserve Bank of India Act, 1934 has defined the main functions of the RBI as follow:

- **Monetary authority**
- **Regulator and supervisor of the financial system**

- **Manager of exchange control**
- **Development role**
- **Related functions**

The RBI Act 1934 was commenced on April 1, 1935. The Act, 1934 provides the statutory basis of the functioning of the bank. The bank was constituted for the need of following:
- To regulate the issues of banknotes.
- To maintain reserves with a view to securing monetary stability
- To operate the credit and currency system of the country to its advantage.

Functions of RBI as a central bank of India are explained briefly as follows:

Bank of Issue:

The RBI formulates, implements, and monitors the monitory policy. Its main objective is maintaining price stability and ensuring adequate flow of credit to productive sector.

Regulator-Supervisor of the financial system:

RBI prescribes broad parameters of banking operations within which the country's banking and financial system functions. Their main objective is to maintain public confidence in the system, protect depositor's interest and provide cost effective banking services to the public.

Manager of exchange control:

The manager of exchange control department manages the foreign exchange, according to the foreign exchange management act, 1999. The manager's main objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

Issuer of currency:

A person who works as an issuer, issues and exchanges or destroys the currency and coins that are not fit for circulation. His main objective is to give the public adequate quantity of supplies of currency notes and coins and in good quality.

Developmental role:

The RBI performs the wide range of promotional functions to support national objectives such as contests, coupons maintaining good public relations and many more.

Related functions:

There are also some of the related functions to the above mentioned main functions. They are such as, banker to the government, banker to banks etc…

- Banker to government performs merchant banking function for the central and the state

governments; also acts as their banker.
• Banker to banks maintains banking accounts to all scheduled banks.
Controller of Credit: RBI performs the following tasks:
• It holds the cash reserves of all the scheduled banks.
• It controls the credit operations of banks through quantitative and qualitative controls.
• It controls the banking system through the system of licensing, inspection and calling for information.
• It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

Supervisory Functions:

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

Promotional Functions:

With economic growth assuming a new urgency since independence, the range of the Reserve Bank's functions has steadily widened. The bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve bank was asked to **promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies.**

B. BANKING REGULATION ACT, 1949

The Banking Regulation Act, 1949 is one of the important legal frame works. Initially the Act was passed as Banking Companies Act, 1949 and it was changed to Banking Regulation Act 1949. Along with the Reserve Bank of India Act 1935, Banking Regulation Act 1949 provides a lot of guidelines to banks covering wide range of areas. Some of the

important provisions of the Banking Regulation Act 1949 are listed below.

- The term banking is defined as per Sec 5(i) (b), as acceptance of deposits of money from the public for the purpose of lending and/or investment. Such deposits can be repayable on demand or otherwise and withdraw able by means of cheque, drafts, order or otherwise
- Sec 5(i)(c) defines a banking company as any company which handles the business of banking
- Sec 5(i)(f) distinguishes between the demand and time liabilities, as the liabilities which are repayable on demand and time liabilities means which are not demand liabilities
- Sec 5(i)(h) deals with the meaning of secured loans or advances. Secured loan or advance granted onthe security of an asset, the market value of such an asset in not at any time less than the amount of such loan or advances. Whereas unsecured loans are recognized as a loan or advance which is not secured
- Sec 6(1) deals with the definition of banking business
- Sec 7 specifies banking companies doing banking business in India should use at least on work bank,banking, banking company in its name
- Banking Regulation Act through a number of sections restricts or prohibits certain activities for a bank.For example:
  - (i) Trading activities of goods are restricted as per Section 8
  - (ii) Prohibitions: Banks are prohibited to hold any immovable property subject to certain terms and conditions as per Section 9. Further, a banking company cannot create a charge upon any unpaid capital of the company as per Section 14. Sec 14(A) stipulates that a banking company also cannot create a floating charge on the undertaking or any property of the company without the prior permission of Reserve Bank of India
  - (iii) A bank cannot declare dividend unless all its capitalized expenses are fully written off as per Section 15.

Sec. 10 : Tenure of CMD cannot exceed 5 yrs at a time

Sec.11: Foreign banks paid –up capital and reserves > Rs.20 Lakh

Sec.12: Ratio of Authorized: Subscribed: Paid-up Capital – 4:2:1

Sec.13: Bank cannot pay commission, Brokerage, ect. More than 2.5% of paid up value of one share.

Sec.14: Prohibits a bank from creating floating charges on any property of the company.

Se.15: Prohibits dividend till all capitalized expenses are written off.

Sec.16: Prohibits a person to be appointed as Director of more than one bank.

Sec.17: Every year a bank is required to transfer min. 20% of profit before dividend to a reserve fund.

Sec.18: Every unscheduled bank has to maintain in India a cash reserve with itself or RBI @3% of total Demand and time liabilities.

Sec.20: Prohibits advances against the bank's own shares

Sec.21: Empower RBI to control advances by the banking company.

Sec.21A: Rate interest charged by bank can not be re-opened by court

Sec.22: Empowers RBI to issue license for opening of a bank.

Sec.23: Prior RBI permission required for opening a new branch

Sec.23 (1): No RBI permission is required to change of premises within same city

Sec.35A: Interest of Deposits/ Advances rounded off to the nearest multiple of Rs.1.

Sec.24: Statutory Liquidity Ratio 25%.

Sec.25: Assets of the banks on last quarterly Friday shall not be less than 75% of its D & TL.

Sec.26: Return of unclaimed deposits 10 yrs and above

Sec.29: Preparation of final P&L accounts and balance sheet.

Sec.31: Publish balance sheet and auditor's report within 3 yrs.

Sec.35: No bank can open an office abroad without permission of RBI.

Sec.36AD: No person shall obstruct the transactions of normal business by the bank in any manner.

Sec.44A: Procedure for amalgamation of banking company

Sec.45: Power of RBI to apply to the central Govt for suspension of business by a banking company.

Sec.45Y: Central Govt. specifies the period of preservation of books a/cs (5yrs now).

Sec.45Z: A customer has a right to ask the bank to return him a paid instrument any time.

Sec.45ZY: While returning a paid instrument, bank must retain its true copy of all relevant parts.

Sec.45ZF: Nomination.

C. NEGOTIABLE INSTRUMENTS ACT 1881

According to Section 13 (a) of the Act, "Negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or " bearer" appear on the instrument or not."

Types of Negotiable Instrument

Section 13 of the Negotiable Instruments Act states that anegotiable instrument is a promissory note, bill of exchange or a chequepayable either to order or to bearer. Negotiable instruments recognized by statute are:

(i) **Promissory notes**
(ii) **Bills of exchange**
(iii) **Cheques.**

Promissory notes

Section 4 of the Act defines, "A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments."

Bill of exchange

Section 5 of the Act defines, "A bill of exchange is an instrument inwriting containing an unconditional order, signed by the maker, directinga certain person to pay a certain sum of money only to, or to the order ofa certain person or to the bearer of the instrument".A bill of exchange, therefore, is a written acknowledgement of thedebt, written by the creditor and accepted by the debtor. There areusually three parties to a bill of exchange drawer, acceptor or draweeandpayee. Drawer himself may be the payee.

Cheques

Section 6 of the Act defines "A cheque is a bill of exchange drawnon a specified banker, and not expressed to be payable otherwise than ondemand".

A cheque is bill of exchange with two more qualifications, namely,

(i) It is always drawn on a specified banker, and
(ii) It is always payableon demand. Consequently, all chequeis bill of exchange, but all billsare not cheque. A cheque must satisfy all the requirements of a bill

ofexchange; that is, it must be signed by the drawer, and must contain anunconditional order on a specified banker to pay a certain sum of moneyto or to the order of a certain person or to the bearer of the cheque. Itdoes not require acceptance.

NEW BANK LICENSING POLICY, 2013

Over the last two decades, the Reserve Bank of India (RBI) gave license to twelve banks in the private sector. This happened in two phases. Ten banks were licensed on the basis of guidelines issued in January 1993. The guidelines were revised in January 2001 based on the experience gained from the functioning of these banks, and fresh applications were invited. The applications received in response to this invitation were vetted by a High Level Advisory Committee constituted by the RBI, and two more licenses were issued, to two entities, viz., Kotak Mahindra Bank and Yes Bank. While preparing these guidelines, the Reserve Bank recognized the need for an explicit policy on banking structure in India keeping in view the recommendations of the Narasimham Committee, RaghuramRajan Committee and other viewpoints.

RIGHTS AND OBLIGTIONS OF BANKER

The relationship between a banker and his customer depends upon the nature of service provided by a banker. Accepting deposits and lending and/or investing is the core banking businesses of a bank. In addition to its primary functions, it deals with various customers by providing other services like safe custody services, safe deposit lockers, and assisting the clients by collecting their cheques and other instruments as an agent and trustees for them. So, based on the above a banker customer relationship can be classified as under:

Banking Company

A banking company is defined as a company which transacts the business of banking in India. Section 5 (b) of TheBankingRegulationAct,1949 defines the term 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.

Features of Banking

The following are the basic characteristics to capture the essential features of Banking:

(i) Dealing in money

The banks accept deposits from the public and advance the same as loans to the needy people. The deposits may be of different types - current, fixed, savings, etc. accounts. The deposits are accepted on various terms and conditions.

(ii) Deposits must be withdrawable

The deposits (other than fixed deposits) made by the public can be withdrawable by cheques, draft or otherwise, *i.e.,* the bank issue and pay cheques. The deposits are usually withdrawable on demand.

(iii) Dealing with credit

The banks are the institutions that can create credit *i.e.,* creation of additional money for lending. Thus, "creation of credit" is the unique feature of banking.

(iv) Commercial in nature

Since all the banking functions are carried on with the aim of making profit, it is regarded as a commercial institution.

(v) Nature of agent

Besides the basic function of accepting deposits and lending money as loans, bank possesses the character of an agent because of its various agency services.

Meaning of Customer

For the purpose of KYC policy, a 'Customer' is defined as:

– A person or entity that maintains an account and/or has a business relationship with the bank;

– One on whose behalf the account is maintained (i.e. the beneficial owner);

– beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and

– any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

OBLIGATIONS OF A BANKER

- **Obligation to honour cheques**
- **Obligation to maintain secrecy and disclosure of information required by law**
- **Obligation to keep a proper record of transactions**
- **Obligation to abide by the instructions of the customer**

(i) Obligation to honour cheques

Banker accepts the deposits from the customer with an obligation to repay it to him on demand or otherwise. The banker is therefore under a statutory obligation to honour his customer's cheques because; it is recognized under section 31 of the NI Act, 1881-

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 the banker is bound to honour his customer's cheques provided the following conditions are fulfilled-

(a) Sufficient balance in customer's account
(b) Presentation of cheques within working hours of business
(c) Presentation of cheques within reasonable time after ostensible date of its issue
(d) Cheques should be presented at the branch where account is kept
(e) Fulfillment of requirements of law

(ii) Obligation to maintain secrecy and disclosure of information required by law

The banker is under an obligation to take utmost care in keeping secrecy about the accounts of the customers since it may affect his reputation, credit-worthiness and business. It was firmly laid down in Tournier v. National Provincial and Union Bank of England Ltd. in India it was made compulsory after 1970. The duty to maintain secrecy will be continuing even after the account is closed or the death of the customer. This obligation is subject to certain exceptions.

(iii) Obligation to keep a proper record of transactions

The banker must keep a proper record of transactions of the customer. If he wrongly credits the account of the customer and intimates him with the same and the customer acts upon the intimation bonafide and withdraws cash the banker cannot contend that the entries were wrongly made. He shall not succeed in recovery of money from the customer.

(iv) Obligation to abide by the instructions of the customer

The banker must abide by any express instructions of the customer provided it is within the scope of their banker-customer relationship. In the absence of any express instructions, the banker must according to prevailing usages at the place where the banker conducts his business.

RIGHTS OF A BANKER

- **Banker's right of general lien**
- **Banker's right of set-off**
- **Banker's right for appropriation of payment**
- **Banker's right to claim incidental charges**
- **Banker's right to charge compound charges**

i. Banker's right of general lien

One of the important rights enjoyed by a banker is the right of general lien. Lien means the right of the creditor to retain goods and securities owned by the debtor until the debt due from him is paid. It may either be general or particular. In Brando v. Barnet, it was held that bankers most undoubtedly have a general lien on all securities deposited with them as bankers unless there is an express or implied contract inconsistent with lien.

In India sec 171 of the Indian Contract Act confers general lien upon bankers as follows- bankers…..may in absence of a contract to the contrary, retain as a security for a general balance of account, any goods bailed to them.

ii. Banker's right of set-off

The right to set off is a statutory right which enables debtor to take into account a debt owing to him by a creditor, before the latter could recover the debt due to him from the debtor. Thus when a customer keeps two or more accounts at the same bank, some of which are overdrawn and some in credit, the bank has a right to combine such accounts and pay the resultant balance. In Halesowen Press cook and Assemblies Ltd v. West minister Bank Ltd, it was held that a banker has the right to combine two accounts and to set off unless he has made some agreement express or implied to the contrary.

iii. Banker's right for appropriation of payment

When a debtor owes two or more debts to a creditor and he pays some amount which is not sufficient to meet any debt to the creditor appropriation is done. It applies to a banker if the customer has more than one deposit or more than one loan account.

In Devaynes v. Noble, famously known as Clayton's case, a principle was laid down as to when the customer has current account and deposits and withdraws money frequently the first item on debit side will be discharged by the first item on credit side. The credit entries in the account adjust or set off the debit entries in chronological order.

iv. Banker's right to claim incidental charges

The banker may claim incidental charges on unremunerative accounts such as service charges, processing charges, and ledger folio charges, appraisal charges, penal charges and so on.

v. Banker's right to charge compound charges

A banker has a special privilege to charge compound interest. In Syndicate Bank v. West Bengal Cement Ltd, the adding of unpaid interest due to the principal amount is recognized. However, the SC abolished this in case of agricultural loans in the Bank of India case.

CIRCUMSTANCES THE BANKERS CANNOT MAINTAIN SECRECY

The duty of the banker to maintain the secrecy is not an absolute one. It is also subject to certain exceptions. The exceptions were stated in the landmark judgment **Tournier v National Provincial Bank Limited**. **Section 13** of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 also allows certain exceptions.

A. Disclosure under the compulsion of Law

Banker's obligation to his customer is subject to his duty to the law of the country. The baker would, therefore, be justified in disclosing information to meet the following statutory requirements.

(i) Under the Income –Tax Act, 1961

Vide Section 131 & 133, Income Tax authorities have powers to call for the attendance of any person or for necessary information from banker for the purpose of assessment of the bank's customers.

(ii) Under the Banker's Books Evidence Act, 1891

A banker may be asked for the Court to produce a certified copy of his customer's account in his ledger.

(iii) Under the Reserve Bank of India,1934

The RBI is empowered to collect credit information from Banking Companies relating to their customers

(iv) Under the Banking Regulation Act, 1949

Every bank is compelled to submit an annual return of deposits which remain unclaimed for 10 years.

(v) Under the garnishee order

When a garnishee order nisi is received, the banker must disclose the nature of the account of a customer to the Court.

(vi) Under the Companies Act, 1956

When the Central Government appoints an inspector to investigate the affairs of any joint-stock company under section 135 or section 137 of the Companies Act, the banker must produce all books and papers relating of the Company.

(vii) Under Criminal procedure code

The police officers conducting an investigation may also inspect the banker's books for the purpose of such investigation.

B. **Disclosure in the interest of the public**-the following grounds generally fall under this category

i. Disclosure of the account where money is kept for extreme political purposes in contravening the provisions of any law
ii. Disclosure of the account of an unlawful association
iii. Disclosure of the account of a revolutionary or terrorist body to avert danger to the State
iv. Disclosure of the account of an enemy in time of war
v. Disclosure of the account where sizable funds are received from foreign countries by a constituent.

C. Disclosure in the interest of the bank

The banker may disclose the state of his customer's account in order to legally protect his own interest. For example- if the baker has to recover the dues from the customer or the guarantor, disclosure of necessary facts to the guarantor or the solicitor becomes necessary and is justified.

D. Disclosure under the express or implied consent of a customer

The customer may instruct his banker to give some or all other particulars of his account to say, his auditor, in such case banker can disclose. Banker can also disclose to a referee whose name is suggested by the customer. It is implied that the banker can disclose information to the guarantor.

E. Disclosure under Banker's enquiry

It is an established banking practice to provide credit information about their customers by one bank to another. The customer gives implied consent to this practice at the time of opening the account.

Cash Reserve Ratio (CRR)

Cash reserve ratio (CRR) is generally defined as a particular minimum amount of deposits that needs to be maintained as a reserve by every commercial bank in India according to the requirement of the RBI. The CRR will be fixed as per the rules and regulations of the RBI.

CRR stands for Cash Reserve Ratio. It is a compulsory reserve that the central bank of the country – The Reserve Bank of India (RBI), must maintain. Every commercial bank is obligated to maintain CRR, which is a specified percentage of their net demand and time liabilities (NBTL)

Commercial banks must maintain the CRR in the form of cash balances with the RBI. These banks are not allowed to use the money for economic or commercial purposes.

Why Does a Bank Need to Maintain Cash Reserve Ratio (CRR)?

When every bank maintains the necessary CRR, the overall liquidity will be administered and managed thoroughly. This, in turn, will benefit each bank also. A bank will always have the right amount of cash and not fall short of funds when depositors or customer require funds for their various personal needs. This is a very good advantage for any bank's operations.

However, one needs to note that when the CRR maintained with the RBI is high, the liquidity will be low in the economic system. It works vice versa wherein the lower the CRR maintained with the RBI, the higher will be the overall liquidity of the financial system.

Cash Reserve Ratio (CRR) is the share of a bank’s total deposit that is mandated by the Reserve Bank of India (RBI) to be maintained with the latter as reserves in the form of liquid cash.

CRR stands for Cash Reserve Ratio. It is a compulsory reserve that the central bank of the country – The Reserve Bank of India (RBI), must maintain. Every commercial bank is obligated to maintain CRR, which is a specified percentage of their net demand and time liabilities.

Commercial banks must maintain the CRR in the form of cash balances with the RBI. These banks are not allowed to use the money for economic or commercial purposes.

Essentially, CRR represents the minimum percentage of deposits that a commercial bank must keep as a cash reserve with the RBI. The RBI uses CRR to maintain liquidity and cash flow in the economy.

Current cash reserve ratio is at 4%, this will be changed to 4.5% from May 21st.

Cash Reserve Ratio (CRR) is one of the main components of the RBI’s monetary policy, which is used to regulate the money supply, level of inflation and liquidity in the country. The higher the CRR, the lower is the liquidity with the banks and vice-versa. During high levels of inflation, attempts are made to reduce the flow of money in the economy.

Statutory Liquidity Ratio

Statutory Liquidity Ratio popularly called SLR is the minimum percentage of deposits that the commercial bank maintains through gold, cash and other securities. However, these deposits are maintained by the banks themselves and not with the RBI or Reserve Bank of India.

Current SLR in India – 18.00%

SLR stands for Statutory Liquidity Ratio. It is an obligatory reserve that commercial banks must maintain. Commercial banks may maintain this reserve requirement in the form of approved securities per a specific percentage of the net demand and time liabilities.

SLR can also be defined as a tool used to maintain the stability of the banks by restricting the credit facility they offer to their customers. Banks usually hold more than the required SLR, per RBI norms stating that they must maintain a certain amount of money as liquid assets. This helps banks fulfil their depositors' demands as and when they arise

The following are the key differences between CRR and SLR:

Parameters	CRR	SLR
Meaning	It is a percentage of money that a bank has to keep with the RBI.	It is a proportion of liquid assets per a percentage of time and demand liabilities.
Form	Maintained in the form of cash.	Maintained in the form of cash, gold and government-approved securities.
Uses	Regulates the flow of money in the economy.	Ensures the solvency of banks.
Reserved With	Reserved with the RBI.	Reserved with commercial banks.
National Impact	Regulates the liquidity of cash in the country.	Maintains the credit growth of the country.

BASIC UNDERSTANDING OF NON- PERFORMING ASSET

A Non–Performing Asset (NPA)is defined as a credit facility in respect of which the interest and or installments of principal has remained 'past due' for a specific period of time.

An assets including leased asset, becomeaNon –performing asset when it ceases to generate income for the bank. An NPA is a loan or advance where the interest and or installment of principal remain over due for a period of more than ninety (90) days in respect of a term loan.

An account remains 'out of order' as indicated below in respect of an overdraft/cash draft.

A bill remains over due for a period of more than ninety days, in the case of bills purchased and discounted.

A **Non-performing asset** (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained 'past due' for a specified period of time. In simple terms, an asset is tagged as non performing when it ceases to generate income for the lender.

Out of order status:

An account is treated as **"Out of order"**, if the outstanding balance remains continuously in **excess** of the sanctioned limit/drawing power. In cases, where the outstanding balance in the operating account is less than the sanctioned limit/drawing power, but there are no credit continuously for 90 days or credits are not enough to cover the interest debited during the same period,these account is to be treat as out of order.

How to Identify NPA

With a view to moving towards international best practices and to ensure greater transparency, it had been decided to adopt the '90 days' overdue' norm for identification of NPA, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) is a loan or an advance where;

- Interest and/or installment of principal remain overdue for a period of more than 91 days in respect of a term loan,
- The account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

- Non submission of Stock Statements for 3 Continuous Quarters in case of Cash Credit Facility.
- No active transactions in the account (Cash Credit/Over Draft/EPC/PCFC) for more than 91days

Reasons for Occurrence of NPAs

NPAs result from what are termed "Bad Loans" or defaults. Default, in the financial parlance, is the failure to meet financial obligations, say non-payment of a loan installment. These loans can occur due to the following reasons:

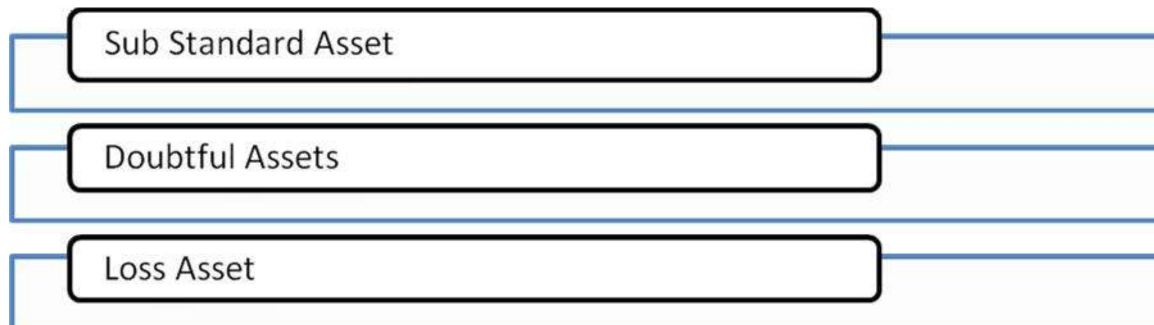
- Usual banking operations /Bad lending practices
- A banking crisis (as happened in South Asia and Japan)
- Overhang component (due to environmental reasons, natural calamities,business cycle,Disease Occurrence,etc...)
- Incremental component (due to internal bank management, like credit policy, terms of credit, etc...)

The Problems caused by NPAs

NPAs do not just reflect badly in a bank's account books, they adversely impact the national economy. Following are some of the repercussions (consequence) of NPAs:

- Depositors do not get rightful returns and many times may lose uninsured deposits. Banks may begin charging higher interest rates on some products to compensate Non-performing loan losses
- Bank shareholders are adversely affected
- Bad loans imply redirecting of funds from good projects to bad ones. Hence, the economy suffers due to loss of good projects and failure of bad investments
- When bank do not get loan repayment or interest payments, liquidity problems may ensue.

Categories of NPA s:



Banks are required to classify non-performing asset into following three categories based on the period for which the asset has remained non- performing and reliability of the dues:

1. **Sub-standard NPA** - When the account holder does not pay 3 installments continuously after 90 days up to 1 year. In this case bank has made 10% provision of funds from their profit to meet the losses generated from NPA.(Which has remained NPA for a period less than or equal to 12 months. - a substandard asset is one which has been classified as NPA for a period not exceeding 12 months.)
2. **Doubtful NPA** –There are 3 sub categories. i.e., up to 1 year (20% provision made by bank), Up to 2 year (30% provision made), Up to 3 year (100% provision made by the bank).Which has remained NPA for a period more than 12 months - a doubtful asset is one which has remained NPA for a period exceeding 12 months.)
3. **Loss assets** – In this case 100% provision is made by bank. The account can be written off and all the assets will hand over to recovery agents for sale.Where loss has been identified by the bank, internal or external auditor or central bank inspectors. But the amount has not been written off, wholly or partly.

PREVENTIVE MEASURES FOR NPA

- Identifying borrowers with genuine intent
- Early recognition of the problem accounts
- Timeliness & adequacy of response
- Monitoring of credit turnover in CC/OD A/cs.
- Containing diversion of funds, Monitoring willful defaulters.
- Adequacy of collateral security in case of large borrowed accounts

UNDERSTANDING BANKING FINANCIAL STATEMENTS

A bank's financial statements are quite different from those of a firm in any other industry.

Bank liabilities

Sources of bank funds are classified according to the type of debt and equity components. The various debt instruments are differentiated on the basis of the maturity, cheque writing and other facilities, the insurance they carry and their tradability in the markets.

Net worth

The new worth of a bank is measured by the aggregate of its share capital, reserve and surplus. In any enterprise, capital is required to absorb unexpected losses. A bank typically sustains losses when the value of its assets is eroded – leading to fall in profitability due to loss of income. The loss in liquidity when the value of assets is eroded may even threaten the very existence of the bank.

Deposit

The primary source of borrowed funds for a typical bank is deposit – predominantly raised from the public. We will see in subsequent chapters the nationale and implications of banks garnering household corporate and government savings in order to channelize them to deficit sectors in the economy, thus leading to capital formulation. Deposit are grouped for transaction as well as balance sheet purpose based on purpose and maturity.

Borrowings

Banks can borrow from the markets, both domestic and oversea, other institutions and banks, and from the central bank. Such borrowings, typically contribute a lower proportion to the bank' total sources of funds, generally borrowings are used to shore up the liquidity position or create specific assets.

Bank assets

As financial intermediaries, bank typically trade in credit, thus, leading to economic growth. The funds mobilized from various sectors in the economy are deployed into productive sectors of the economy. The bank's most important asset balance sheets. Banks also aid economic growth by investing in securities issued through the financial markets and government.

Investment

- Investment securities help banks in several ways.
- They help to meet liquidity needs, earn interest, take advantage of interest rate movement and are a part of the banks treasury functions
- Liquidity risks can be offset by investing in short term securities, ranging from overnight to 1 year, which can be sold at a price very close to the acquisition cost.
- For the additional liquidity banks are willing to sacrifice higher returns that are possible in long-term investment securities.

Loans and advances

This category of assets is the most important for banks because it defines their roles as financial intermediaries and impacts their profitability to large extent. Each assets of carry high level of default risk and exhibits unique characteristics that render generalizations and monitoring difficult.

Fixed assets

In sharp contrast to other industrial and service sectors, banks own relatively few fixed assets. Compared to non – financial firms, banks operate with lower fixed costs and exhibit lower operating leverage.

Contingent Liabilities

A contingent liability, on the other hand is a possible obligation, which could arise depending on whether some uncertain future event occurs. It could also arise where there is a present obligation, but payment is not probable or the amount cannot be measured reliably.

The major risk in contingent liabilities is the counter party default risk. In the event of the counter party failing to honour his commitment, the liability will crystallize into a fund – based liability for the bank. Relatively higher fees for these services offset the higher risk.

The Income Statement

- The income statement starts with interest income from advances and investment.
- Interest payment on deposit and borrowings are deducted from interest income to arrive at net interest income. The NII is an important measure of profitability for banks and is used for calculating the spread.
- The NII can be likened to gross profit or contribution in a non- financial firm.

(Spread - Net interest spread *refers to the difference in borrowing and lending rates of financial institutions (such as* banks*) in nominal terms.)*

Other income

As pointed out earlier, banks are increasing their earnings through fee based services, such as fund transfer and remittances, custodial services, collections government business, agency business, opening letters of credit, issuing letters of guarantee and dealing in derivative markets.

Interest Expended

This represents variable cost for the bank. However, due to the variety of borrowed sources of funds in terms of tenure, price and covenants, keeping this cost in check is a challenge for banks. Banks typically operate on narrow spreads and any increase in interest expanded is bound to erode profit, unless matched by commensurate growth in income generated by assets.

BANK LIABILITIES

Capital

Banks have to show the authorized, subscribed and paid – up capital under this head. The RBI guidelines for the minimum capital to be held by bans in India – both private and foreign.

RBIGuideline

(i) The initial minimum paid-up capital for a new bank shall be Rs.200 crore. The initial capital will be raised to Rs.300 crore within three years of commencement of business. The overall capital structure of the proposed bank including the authorised capital shall be approved by the RBI.

(ii) The promoters' contribution shall be a minimum of 40 per cent of the paid-up capital of the bank at any point of time. The initial capital, other than the promoters' contribution, could be raised through public issue or private placement.

Reserve and Surplus

Indian banks have to include the following components under this head.

Statutory Reserves

Under section 17(1) of the banking regulation Act,1949, every banking company incorporated in India shall create a reserve fund out of the balance of profit each year as disclosed in the profit and loss account.

Capital Reserves

Excess depreciation on investments, or profit on sale of permanent investments or assets, are some of the surpluses that will be carried to the capital reserve account.

Share Premium

Premium on the issue of share capital by the bank

Revenue and other reserves

This will comprise all other reserves not included above. Excess provision on depreciation on investment will have to be appropriated to the investment reserve account.

Balance in profit and loss account: This contains the balance of profit after appropriations

Deposit

Deposits are classified three types

- Demand deposit
- Savings deposit
- Term deposit

Borrowings

Banks can borrow from the markets, both domestic and oversea, other institutions and banks, and from the central bank. Such borrowings, typically contribute a lower proportion to the bank' total sources of funds, generally borrowings are used to shore up the liquidity position or create specific assets.

Other Liabilities and Provisions

Bills Payable

These constitute the floating liabilities of banks arising out of fee – based services rendered by banks for funds transfer, such as demand drafts, bankers' cheques and travelers cheques

Inter – Office Adjustments

The net credit balance will be included under liabilities.

Interest Accrued

Interest accrued on deposit and borrowings, which are due for payment, would be included in the balances outstanding under deposit or borrowings. Interest accrued but not due for payment will get reflected under this head.

Others

Importantly, this head would reflect the provisions made for income tax, bad debts and depreciation in securities. Other liabilities that cannot be grouped under any other head, such as unclaimed dividends, provisions or funds earmarked for specific purposes, and unexpired discount are also classified under this head.

Bank Assets

The following broad categories of assets are typically detailed in Indian bank's balance sheets;

- Cash and balances with RBI
- Balances with banks and money at call and short notice

  One of the assets that appears in the balance sheet of a bank. It includes funds lent to discount houses, money brokers, the stock exchange, bullion brokers, corporate customers, and increasingly to other banks. 'At call' money is repayable on demand, whereas 'short notice' money implies that notice of repayment of up to 14 days will be given. After cash, money at call and short notice are the banks' most liquid assets. They are usually interest-earning secured loans but their importance lies in providing the banks with an opportunity to use their surplus funds and to adjust their cash and liquidity requirements.

- Investments
- Advances
- Fixed assets
- Other assets

Income Statement of Banks

Interest Earned

Interest earned is categorized as follow

- Interest / discount on advance / bills: Banks charge interest on almost all types of advances. However, they discount certain types of bills, implying that the bank charges are taken upfront. Both categories of income are included under this head.
- Income from investment: the dividend and interest income earned from the bank\s investment portfolio are included under this head.
- Interest on balances with the RBI and other inter – bank funds: interest earned from sources, such as balances kept with the RBI deposit with other banks, and call loans, are included under this head.
- Others: all other types of interest / discount income that do not fall in any of the above categories will find a place under this head.

Other Income

- Commission, exchange and brokerage: all the types of fee based income describe above fall under this category
- Profit / loss on sale of investment: the net position of gains or losses from sale of securities is shown under this head.
- Profit / loss on sale of building and other assets: the net position of gains or losses from sale of fixed assets including gold and silver will be shown under this head.
- Income earned by way of dividends: these will be applicable to dividends earned from subsidiaries, joint ventures or companies in which the bank has invested.

Expenses

Interest Expended

The income statement lists three categories of interest expenses, based on the source of liabilities.

- Interest on deposits: this head will include interest paid on all types of deposits raised from the public other banks and institutions.
- Interest on RBI / inter – bank borrowings: this head includes / discount on borrowings / refinance form other banks / RBI
- Other interest: This would include interest on subordinated debt or borrowings / refinance from other financial institutions.

Operating Expenses

These expenses are typically the overheads and other expenses necessary for a bank to functions. They are categorized as follow:

- Payment to and provisions for employees
- Rent , taxes and lighting
- Printing and stationary
- Advertisement and publicity
- Depreciation on bank's property
- Director fees, allowance and expenses
- Auditors fees and expenses
- Law charges
- Postage, telephone, etc
- Repairs and maintenance
- Insurance
- Other expenses: if any one category exceeds 1 per cent of total expenses, details of the expenses will have to be provided separately.

Provisions and Contingencies

Provisions made for loan losses, taxes and diminution (reduction) in the value of investments will be included under this head.

CAMELS- AN INTEGRATED SCORECARD FOR BANKS:

Regulators the world over have adopted the CAMELS approach as an integrated approach to measuring bank and finance company performance. In India banks are rated on the basis of their CAMELS scores as a part of RBI's off site surveillance system for banks. Each letter of CAMELS stands for an aspect of bank performance as shown in the following:

➢ **C-Stands for Capital Adequacy------**	**- 20%**
➢ **A -Stands for AssetQuality--------**	**- 20%**
➢ **M - Stands for Management Quality -------**	**- 25%**
➢ **E-Stands for Earnings------------ -----**	**- 15%**
➢ **L -Stands for liquidity, and -------**	**-10%**
➢ **S-Stands for Sensitivity to Market Risk----**	**-10%**

If composite ratings Bank rated as

1-	***Sound in all aspects***
2-	***Fundamentally sound***
3-	***Generally have weaknesses in one or more component***
4-	***Indicate serious unsafe and unsound practices***
5-	***Extremely unsafe and unsound practices***

C- Capital Adequacy rated based on the following consideration

a. Nature and volume of problem assets in relation to total capital and adequacy of LLR and other reserves
b. Balance sheet structure including off balance sheet items, market and concentration risk
c. Nature of business activities and risks to the bank
d. Asset and capital growth experience and prospects
e. Earnings performance and distribution of dividends
f. Capital requirements and compliance with regulatory requirements
g. Access to capital markets and sources of capital
h. Ability of management to deal with above factors

A- Asset Quality based on the following considerations

a. Volume of problem of all assets
b. Volume of overdue or rescheduled loans
c. Ability of management to administer all the assets of the bank and to collect problem loans
d. Large concentrations of loans and insiders loans, diversification of investments
e. Loan portfolio management, written policies, procedures internal control, Management Information System
f. Loan Loss Reserves in relation to problem credits and other assets
g. Growth of loans volume in relation to the bank's capacity

M- Management Quality based on the following factors

a. Quality of the monitoring and support of the activities by the board and management and their ability to understand and respond to the risks associated with these activities in the present environment and to plan for the future
b. Financial performance of the bank with regards to the other CAMELS ratings
c. Development and implementation of written policies, procedures, MIS, risk monitoringsystem, reporting, safeguarding of documents, contingency plan and compliance with laws and regulations controlled by a compliance officer
d. Availability of internal and external audit function
e. Concentration or delegation of authority
f. Compensations policies, job descriptions
g. Response to CBI concerns and recommendations

E -Earnings rated based on the following factors

a. Sufficient earnings to cover potential losses, provide adequate capital and pay reasonable dividends
b. Composition of net income, Volume and stability of the components
c. Level of expenses in relation to operations
d. Reliance on extraordinary items, securities transactions, high risk activities

e. Nontraditional or operational sources
f. Adequacy of budgeting, forecasting, control MIS of income and expenses
g. Adequacy of provisions
h. Earnings exposure to market risks, such as interest rate variations, foreign exchange fluctuations and price risk

L -Liquidity rated by the following factors

a. Sources and volume of liquid funds available to meet short term obligations
b. Volatility of deposits and loan demand
c. Interest rates and maturities of assets and liabilities
d. Access to money market and other sources of funds
e. Diversification of funding sources
f. Reliance on inter-bank market for short term funding
g. Management ability to plan, control and measure liquidity process. MIS.
h. Contingency plan

S- Sensitivity Market risk based at the following evaluation factors

a. Sensitivity to adverse changes in interest rates, foreign exchange rates, commodity prices, fixed assets
   - Nature of the operations of the bank
   - Trends in the foreign currencies exposure
   - Changes in the value of the fixed assets of the bank
   - Importance of real estate assets resulting from loans write off

b. Ability of management to identify, measure and control the market risks given the bank exposure to these risks.

BA4003/ BANKING & FINANCIAL SERVICES

UNIT–2

MANAGING BANK FUNDS/ PRODUCTS & RISK MANAGEMENT

Capital Adequacy:

A ratio that can indicate a bank's ability to maintain equity capital sufficient to pay depositors whenever they demand their money and still have enough funds to increase thebank's assets through additional lending. Banks list their capital adequacy ratios in their financial reports. It is stated in terms of equity capital as a percent of assets. Capital requirements imposed by regulators tend to be simple mechanical rules rather than applications of sophisticated risk models.

According to Reed Business Information Limited, the Capital Adequacy Ratio (CAR) "determines the capacity of the bank in terms of meeting the time liabilities and other risks such as credit risk, operational risk, etc. CAR below the minimum statutory level indicates that the bank is not adequately capitalized to expand its operations. The ratio ensures that the banks do not expand their business without having adequate capital."

$$CAR = \frac{\text{Tier 1 Capital} + \text{Tier 2 Capital}}{\text{Risk Weighted Assets}}$$

The framework divides the capital of banks into two tiers:

Tier I comprises:

Ordinary share capital, audited revenue reserves, future tax benefits, and intangible assets.

Tier II comprises:

Unaudited retained earnings, general provisions for bad debts, revaluation reserves, perpetual subordinated debt, perpetual cumulative preference shares, and subordinated debt.

Risk Adjusted Assets:

Risk weighted assets is a measure of the amount of a bank's assets, adjusted for risk. The nature of a bank's business means it is usual for almost all of a bank's assets will consist of loans to customers. Comparing the amount of capital a bank has with the amount of its assets gives a measure of how able the bank is to absorb losses. If its capital is 10% of its assets, then it can lose 10% of its assets without becoming insolvent.

Capital Adequacy Ratio

Capital adequacy ratio (CAR) is a specialized ratio used by banks to determine the adequacy of their capital keeping in view their risk exposures. Banking regulators require a minimum capital adequacy ratio

so as to provide the banks with a cushion to absorb losses before they become insolvent. This improves stability in financial markets and protects deposit-holders.

Formula

$$\text{Capital Adequacy Ratio} = \frac{\text{Tier 1 Capital} + \text{Tier 2 Capital}}{\text{Risk-weighted Exposures}}$$

Tier 1 Capital = Common Equity Tier 1 + Additional Tier 1

Total Capital = Tier 1 Capital + Tier 2 Capital

Risk-weighted exposures include weighted sum of the banks credit exposures (including those appearing on the bank's balance sheet and those not appearing). The weights are determined in accordance with the Basel Committee guidance for assets of each credit rating slab.

Example : Calculate capital adequacy ratio i.e. total capital to risk weighted exposures ratio for Small Bank Inc. using the following information:

	Exposure	**Risk Weight**
Government Treasury held as asset	1,500,000	0%
Loans to Corporates	15,000,000	10%
Loans to Small Businesses	8,000,000	20%
Guarantees and other non-balance sheet exposures	6,000,000	10%

The bank's Tier 1 Capital and Tier 2 Capital are Rs.2,00,000 and Rs.3,00,000 respectively.

Solution
Banks's total capital = 2,00,000 + 3,00,000 = Rs.5,00,000
Risk-weighted exposures = Rs.15,00,000×0% + Rs.1,50,00,000×10% + Rs.8,00,000×20% + Rs.6,00,000×10% = Rs.37,00,000

$$\text{Capital Adequacy Ratio} = \frac{\text{Rs.5,00,000/}}{\text{Rs.37,00,000}} = 14\%$$

If the national regulator requires a capital adequacy ratio of 10%, the bank is safe. However, if the required ratio is 15%, the bank might have to face regulatory actions.

Deposit and Non-deposit sources

SOURCES OF BANK FUNDS

A. Own funds	B. Deposit Sources	C. Non Deposit Sources
Share capital Reserve and Surplus	Current Account Saving Bank Account Recurring Deposit Account Fixed Deposit	Loan from central banks Inter Bank Borrowing ADR/GDR Issue of securities Certificate of deposits (CD)

A. OWN FUNDS

Share capital

The capital collected by a joint stock company for its business operation is known as share capital. Share capital is the total amount of capital collected from its shareholders for achieving the common goal of the company as stated in Memorandum of Association.

Reserve and Surplus

Reserves and surplus at the end of an accounting period the company may decide to transfer part of the profits to a reserve and retain the balance in the profit and loss account. The company can use the general reserve for various purposes including issue of bonus shares to shareholders and payment of dividend when profits are insufficient.

B.DEPOSIT SOURCE: Types of Bank Deposits

Current Account

Current Accounts are basically meant for businessmen and are never used for the purpose of investment or savings. These deposits are the most liquid deposits and there are no limits for number of transactions or the amount of transactions in a day. Most of the current account is opened in the names of firm / company accounts. Cheque book facility is provided and the account holder can deposit all types of the cheques and drafts in their name or endorsed in their favour by third parties. No interest is paid by banks on these accounts. On the other hand, banks charge certain service charges, on such accounts.

Features of Current Accounts:

(a) The main objective of Current Account holders in opening this account is to enable them (mostly businessmen) to conduct their business transactions smoothly.

(b) There are no restrictions on the number of times deposit in cash / cheque can be made or the amount of such deposits;

(c) Usually banks do not have any interest on such current accounts. However, in recent times some banks have introduced special current accounts where interest (as per banks' own guidelines) is paid

(d) The current accounts do not have any fixed maturity as these are on continuous basis accounts

Savings Bank Account

These deposits accounts are one of the most popular deposits for individual accounts. These accounts not only provide cheque facility but also have lot of flexibility for deposits and withdrawal of funds from the account. Most of the banks have rules for the maximum number of withdrawals in a period and the maximum amount of withdrawal, but hardly any bank enforces these. However, banks have every right to enforce such restrictions if it is felt that the account is being misused as a current account. Till 24/10/2011, the interest on Saving Bank Accounts was regulated by RBI and it was fixed at 4.00% on daily balance basis. However, w.e.f. 25th October, 2011, RBI has deregulated Saving Fund account interest rates and now banks are free to decide the same within certain conditions imposed by RBI. Under directions of RBI, now banks are also required to open no frill accounts (this term is used for accounts which do not have any minimum balance requirements). Although Public Sector Banks still pay only 4% rate of interest, some private banks like Kotak Bank and Yes Bank pay between 6% and 7% on such deposits. From the FY 2012-13, interest earned up to Rs 10,000 in a financial year on Saving Bank accounts is exempted from tax.

Recurring Deposit

These are popularly known as RD accounts and are special kind of Term Deposits and are suitable for people who do not have lump sum amount of savings, but are ready to save a small amount every month. Normally, such deposits earn interest on the amount already deposited (through monthly installments) at the same rates as are applicable for Fixed Deposits / Term Deposits. These are best if you wish to create a fund for your child's education or marriage of your daughter or buy a car without loans or save for the future.

Under these types of deposits, the person has to usually deposit a fixed amount of money every month (usually a minimum of Rs, 100/- p.m.). Any default in payment within the month attracts a small penalty. However, some Banks besides offering a fixed installment RD, have also introduced a flexible / variable RD. Under these flexible RDs the person is allowed to deposit even higher amount of installments, with an upper limit fixed for the same e.g. 10 times of the minimum amount agreed upon.

These accounts can be funded by giving Standing Instructions by which bank withdraws a fixed amount on a fixed date of the month from the saving bank of the customer (as per his mandate), and the same is credited to RD account.

Recurring Deposit accounts are normally allowed for maturities ranging from 6 months to 120 months. A Pass book is usually issued wherein the person can get the entries for all the deposits made by him / her and the interest earned. Banks also indicate the maturity value of the RD assuming that the monthly installments will be paid regularly on due dates. In case installments are delayed, the interest payable in the account will be reduced and some nominal penalty charged for default in regular payments. Premature withdrawal of accumulated amount permitted is usually allowed (however, penalty may be imposed for early withdrawals). These accounts can be opened in single or joint names. Nomination facility is also available.

Fixed Deposit

All Banks in India (including SBI, PNB, BOB, BOI, Canara Bank, ICICI Bank, Yes Bank etc.) Offer fixed deposits schemes with a wide range of tenures for periods from 7 days to 10 years. These are also popularly known as FD accounts. However, in some other countries these are known as "Term Deposits" or even called "Bond". The term "fixed" in Fixed Deposits (FD) denotes the period of maturity or tenor. Therefore, the depositors are supposed to continue such Fixed Deposits for the length of time for which the depositor decides to keep the money with the bank. However, in case of need, the depositor can ask for closing (or breaking) the fixed deposit prematurely by paying a penalty (usually of 1%, but some banks either charge less or no penalty). (Some banks introduced variable interest fixed deposits. The rate of interest on such deposits keeps on varying with the prevalent market rates i.e. it will go up if market interest rate goes and it will come down if the market rates fall. However, such type of fixed deposits has not been popular till date).

The rate of interest for Fixed Deposits differs from bank to bank (unlike earlier when the same were regulated by RBI and all banks used to have the same interest rate structure. The present trends indicate that private sector and foreign banks offer higher rate of interest.

The earlier trend that private sector and foreign banks offer higher rate of interest is no more valid these days. However, now a day's small banks are forced to offer higher rate of interest to attract more deposits. Usually a bank FD is paid in lump sum on the date of maturity. However, most of the banks have also facility to pay/ credit interest in saving account at the end of every quarter. If one desires to get interest paid every month, then the interest paid will be at a marginal discounted rate. In the changed computerized environment, now the Interest payable on Fixed Deposit can also be easily transferred on due dates to Savings Bank or Current Account of the customer.

C. NON-DEPOSIT SOURCES

Loan from RBI

The central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds.

Inter Bank Borrowing

The interbank lending market is a market in which banks extend loans to one another for a specified term. Most interbank loans are for maturities of one week or less, the majority being overnight. Such loans are made at the interbank rate (also called the overnight rate if the term of the loan is overnight

ADR/GDR

A Global depository receipt (GDR) also known as International depository receipt (IDR), is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. They are the global equivalent of the original American Depository Receipts (ADR) on which they are based. GDRs represent ownership of an underlying number of

shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets.

Issue of Securities

Securities may be represented by a certificate or, more typically, "non-certificated", that is in electronic or "book entry" only form. Certificates may be bearer, meaning they entitle the holder to rights under the security merely by holding the security, or registered, meaning they entitle the holder to rights only if he or she appears on a security register maintained by the issuer or an intermediary. They include shares of corporate stock or mutual funds, bonds issued by corporations or governmental agencies, stock options or other options, limited partnership units, and various other formal investment instruments that are negotiable and fungible.

Certificate of Deposits

Sold by banks, certificates of deposit (better known as CDs) are low-risk –- and relatively low-return — investments suitable for cash you don't need for months or years. If you leave the money alone during the investment period (known as the "term" or "duration"), the bank will pay you an interest rate slightly higher than what you would have earned in a money market or checking account. All gains from CDs are taxable as income, unless they are in a tax-deferred (IRA) or tax-free (Roth IRA) account.

TYPE OF SPECIAL ACCOUNT PROVIDED BY BANKS

No Frill Account

It is a type of account with low/ zero balance requirements but extra features removed. RBI came up with this No-frill concept, because poor people cannot open regular bank accounting having requirements like Rs.5000/- minimum balance etc.So there are no frill accounts for them. So that poor people can open bank accounts and take loans that will save them from the 36% interest rate charged by the evil money lenders.

Joint Account

A joint account is an account that belongs to more than one person. Joint accounts are often set up by couples that are living together or people who have finances that are closely linked. Both current and savings accounts can be opened jointly. Joint accounts can be set up so each individual account holder can use the account or so that all account holders have to authorize transactions. With a joint account, you are liable for any debts run up by other account holders.

Student account

Most banks provide accounts specifically for students in higher education. These are current accounts that have been designed with student finance in mind. They usually offer interest-free overdrafts up to a certain limit to help students cope with the debts that often accumulate while studying.

Business Account

Most people who run businesses have a business account so their business and personal money are kept separate.They are more or less same as Current Accounts.

Escrow Account

An escrow account is a temporary pass through account held by a third party during the process of a transaction between two parties. An escrow account is a temporary pass through account held by a third party during the process of a transaction between two parties. This is a temporary account as it operates until the completion of a transaction process, which is implemented after all the conditions between the buyer and the seller are settled.

Nostro Account: [Ours Account with You]

Nostro Account is a Current account maintained by a domestic bank/dealer with a foreign bank in foreign currency. For example, Current Account of SBI Bank (an Indian bank) with Swiss Bank in Swiss Franc (CHF) currency is a Nostro account.

Vostro Account: [Yours Account with us]

Vostro account is a Current account maintained by a foreign bank with domestic bank in Rupee currency.
For example: Account of Swiss bank in India with SBI in Rupee Currency.

Loro Account: [Our Account of their money with you]

Loro Account is a Current Account Maintained by one Domestic Bank on behalf of other domestic bank in foreign bank in foreign currency. In other word Loro Account is a Nostro Account for one bank who opened the bank and Loro Account for other bank who refers first one account.

For Example: SBI opened Current Account with Swiss bank. If PNB refers that account of SBI for its correspondence, then it is called Loro Account for PNB and it is Nostro Account for SBI.

DESING OF DEPOSIT SCHEMES

1. Recurring Deposit schemes :

i. General features:

Under the schemes, a fixed sum agreed upon by the bankers and customer will be deposited every month for a pre- determined period. At the end of the period, the depositor will be paid the total amount of deposit installments with interest.

ii. **Advantages to the depositor:**

This is intended to be a variant of the saving deposit account with the objective of inculcating regular savings habit.

iii. **Calculating the Maturity amount**:

While operating these accounts, banks should ensure that the effective interest rates on such accounts are identical with those being paid for other similar deposits.

Maturity of RD= RD installment (FVIFA -Future value interest factor of annuity)

Annuity at the end of the period :Future Value of the Annuity at End of the Period (FVAEP) is product of Principal amount (A) and Future Value Interest factor Annuity (FVIFA). In view of formula

FVAEP = A*FVIFA, Where, A = Principal Amount
FVIFA = [(1+k)^n]-1] / k, where k = rate of Interest and n = No. of years

For example : Assuming that Mr. X deposits Rs.1,000 annually in a bank for 5 years at the rate of 10%.Then the value of the deposits after 5 years based on deferred annuity isFVAEP = Rs.1,000(FVIFA) for 10% and 5 year = 1,000*(((1 .10)^5 -1)/0.10) = 1,000 × 6.105 = Rs.6,105

2. Reinvestment Deposit Scheme:

i. General Features :

In this scheme a lump sum amount is invested for a fixed period and repaid with interest on maturity. Interest on the deposit is reinvested at the end of each quarter and hence, there is interest on interest.

ii. Advantages to the depositor:

The depositor can withdraw the interest plus the principal at the end of the tenure, since the interest is not with draw during the depositors period,the maturity value would be higher than in the case of similar schemes.

iii. Calculating the maturity amount:

The maturity amount in re-investment schemes would be the initial deposit multiplied by the effective rate.

Formula Used:

Reinvestment Plan Deposits – Maturity Value (Quarterly Compounding)
$A = P\left(1+\frac{r}{400}\right)^{n} +100$
r = Rate of interest ; n = Number of quarters; P = Principal amount A = Maturity value

3. Fixed Depositor scheme:

i. General Features :

A specific amount is deposited for a fixed term during which the amount cannot generally be with draw .interest can be paid out on a monthly / quarterly/ half-yearly /annual basis.

ii. Advantages to depositors :

Depositors seeking regular income from their fixed investment would prefer this scheme.

iii. Calculating the interest rate to be quoted:

By periodically withdrawing the interest the depositor can actually earn on this interest amount by reinvesting it.

4. Cash certificates:

i. General Features :

This is a variation of the re-investment deposit scheme, where the maturity value will be pre-determined lump sum. The amount of initial deposit will be the issues price of the cash certificates and will be a computed based on the maturity amount or the face value of the cash certificate and the tenure of the deposit.

DEPOSIT PRICING (Pricing of Deposit sources)

The interest rate paid by financial institutions to deposit account holders. Deposit accounts include certificates of deposit, savings accounts and self-directed deposit retirement accounts.

Some commonly used approaches to Deposit pricing

1. **Cost plus margin deposit pricing**:
   This type of pricing encourages banks to determine the deposit rate as one that would be adequate to cover all costs of offering the service, plus a small profit margin.

2. **Market Penetration deposit pricing:**
   This pricing strategy is typically aimed at high growth markets in which bank is determined to garner a large market share. Therefore, banks are tempted to offer either high interest rates, well above the market level or charge customer fees well the market standards.

3. **Conditional pricing:**
   Conditional pricing can be used by banks as a tool to attract the types of depositors they want as customers. Under this pricing technique, the bank will post a schedule of rates or fees for deposits based on size of deposits or account activity.

4. **Upscale target pricing:**
   Upscale target pricing is the use of carefully but aggressively designed deposit advertising programs and deposit pricing schemes to customers with higher levels of income or net worth , such as business owners and managers, doctors , lawyers and other high income households .

5. **Relationship pricing :**
   Relationship pricing typically ensures that the banks best customer get pricing .It involves basing fees charged to a customer not only on the number of services that the customers purchase from the bank, but also on the intensity of use of these services

Loan Management

TYPES OF LENDING - TYPES OF LOANS

1. Fund based lending .
2. Non fund based lending.
3. Asset – based lending.

1. Fund based lending:

This is the most direct form of lending. It is granted as a loan or advance with an actual outflow of cash to the borrower by the bank. In most cases, such lending is supported by prime and or collateral securities.

a) Loans for working capital:

The rationale for banks having built up considerable expertise in funding short term working capital is explained by the nature of the bank liabilities, which are essentially short term in nature.Net working capital (NCW)is measured as the difference between its current assets and current liabilities.

b) Loans for capital expenditure and industrial credit:

Their credit needs will extend beyond a year .term loans are preferred choice in such cases – with maturities of more than 1 year .repayment spread over the life of the asset or depending on the repaying capacity of the borrower.

c) Loan Syndication:

Large project need enormous funding requirement .It may not be possible for one bank to finance the project requirements, from the view of the both capital regulations and the risk of exposure. Syndicated loans are credit granted by a group of banks to a borrower. Syndicated loan, two or more agree jointly to make a loan to a borrower.

d) Loan for agriculture:

- Most of the loans for agriculture are short term loans.
- Agriculture being seasonal in nature, the norms for seasonal industries isapplication.
- They can be linked to working capital loans,in that they used is for purchase of Inventory, such as seeds fertilizer and pesticides and also to pay operatingcosts.
- The sales are realized when harvested crops are sold in the market.
- Long term loans for agriculture are given for investment in land, equipment or livestock.

e) Loans to consumers or retail lending:

Individual consumers generally seek bank finance to purchase durable goods, education, medical care, housing and other expenses.Customers loans can also be classified based on repayment terms as installments loans, credit cards and non -installments loans.

Forms of Fund based Lending

a) **Short term loans:**

- These are loans with maturities of 1 year or less.
- The amount of available based on the estimated peak and funding requirements of the borrowers.
- Interest accrues only on the draw from the line of credit.

b) **Long term loans:**

- More than 1year up to 10 year.
- Fixed assets.
- Structure repayment.
- Full disbursed of loans.
- Long term substitutes to equity.

c) **Revolving credits:** Borrowers can repay the loan, when they can earn money or making profit

- More than 1 year.
- Flexibility to borrowers.
- Current asset and fixed asset.
- Short term and long term converted into devolving.

2. **Non –fund based lending:**

There are no funds outlays for the bank at the time of entering into an agreement with counterparty on behalf of the banks customer .Most contingent liabilities of the bank, more prominently, letters of credit (LGs) and bank guarantees (BGs)fall this category.

i. Loan Guarantee
ii. Bank Guarantees

are the common forms of non – fund –based credit limits granted to borrowers to carry on their business.

3. **Asset based lending:**

This is an emerging category of the bank lending. In this types of lending, the bank looks primarily or solely to the earning capacity of the asset being financed,for servicing its debt . In most cases the bank will have limited or to the borrower. Specialized lending practices, such as securitizations or project finance fall under this category.

- **Loans for infrastructure – project finance**

Project finance involves the creation of a legally independent project company, with equity from one or more sponsoring firms. Non– or limited recourse debt, for the purpose of investing in a single purpose, industrial asset.

LOAN POLICY

These are written documents, authorized by individual bank's Board of Directors, that formalize and set guideline for lending to be followed by Decision- makers in the bank.

The loan policy specifies the bank's overall strategy for lending, identifies loan qualities & parameters and lays down procedures for appraising, sanctioning, granting, documenting and reviewing loan.

Major components of a typical loan policy document

i. Loan objectives
ii. Volume and mix of loans
iii. Loan evaluation procedures
iv. Credit administration
v. Credit files

a) Loan objectives:

Within the regulatory prescriptions, the loan objectives will communicate to credit officers and other decision –makers, the banks priorities among the conflicting of liquidity, profitability, increasing business volumes, and risk and asset quality.

b) Volume and mix of loans:

How much of the loan portfolio is to be channeled into specific industries, sectors or geographical areas, will be communicated in this section.

c) Loan evaluation procedures:

The procedures would deal with all issues ranging from establishing suitability of the loan overall strategy and risk taking ability , to selection of borrowers ,market and project risk appraisal criteria, financial statement analysis ,structuring of the loan agreement , documentation and post –sanction monitoring.

d) Credit administration:

Lending involves more risks than any other banking activity .the loan policy should indicate the credit sanctioning powers of the officers various hierarchical levels of the bank.

e) Credit files:

Credit files are important documented and updated material used for both decision –making and continuous evaluation.

STEPS INVOLVED IN CREDIT ANALYSIS

a) Building the credit file
b) Project and financial appraisal
c) Qualitative analysis
d) Due diligence
e) Risk assessment
f) Making the recommendation

1. Building the credit file:

The first step to effective credit analysis is gathering information to build the credit file. The preliminary information so obtained would throw light on the borrower`s antecedent (past record), his credit history and take record.

2. Project and financial appraisal:

Once the preliminary investigation is done, the internal and external factors such as management integrity and capability, the company's performance and market value and the industries characteristics are evaluated.

a) Past financial statements.

b) Cash flow statements.

c) The from above data from theborrower enables the offer to analyze the liquidity position of the borrower his firm.

d) The financial risk of an entity is measured by the debt .It has incurred in the course of business compared with the owners stake.

e) Once the borrower s current financial health is gauged, the projections are examined.

f) Even the most scientifically done projections cannot predict the onslaught of future uncertainties.

3. Qualitative analysis:

Integrity is the most important quality that the banker looks for in a borrower, and the most to measure .so assessment of the quality of the management team.

4. Due diligence : (an investigation of a business or person prior to signing a contract)

By passing due diligence can be very costly for a bank .due diligence can include checking on the borrowers address ,pre-approval inspections of the borrowers workplace and interviews with the borrower's competitors ,suppliers, customers and employees .

5. Risk assessment :

A key function of the credit officer is to identity and analyze the key risks associated with proposed credit .all potential internal and external risks to be identified and their severity assessed in terms of how these risks would impact the borrowers future cash flows and hence the debt service capacity.

6.Making the recommendation:

Finally , based on a thorough analysis of the project , the borrower and the market , and after examining the `fit` of the credit with the 'loan policy' , the credit officer makes his recommendations to consider the loan favorably or reject it outright.

CREDIT DELIVERY

Disposal or sanctioning of loan to the borrower on the basis of loan application is called Credit delivery.

Modes of Credit delivery

1. Cash credit

The banker delivering the amount of loans &advances in the form of cash by depositing in borrower's (customer's) loan account .

Commitment charges: Bank levies a charge on the unutilized portion of cash limit (Unused loan amount/ not yet withdrawn).

2. Overdrafts

Bank allows his customer to withdraw over and above the borrower's credit balance in his current account. Banker may grant over-draft (O/D) facility to satisfy urgent credit requirements of a borrower against a collateral security or personal guarantee.

3. Bill Finance

When bills of exchange drawn by the borrower or by counter parties of the borrower are discounted by bank.

Clean bill: Not supported by any document of title of goods

Documentary bill – Supported by a document

Supply bill – Given by the buyer to the supplier for his purchases and given acceptance to make payment with in a stipulated period.

4. **Working capital demand loan** – Sanctioned in the form of cash to meet out the working capital requirements of the customers.

5. **Letter of credit:**A **letter of credit** is a document from a bank guaranteeing that a seller will receive payment in full as long as certain delivery conditions have been met. In the event that the buyer is unable to make payment on the purchase, the bank will cover the outstanding amount.

6. **Loan Syndication** - Loan syndication is a lending process in which a group of lenders provide funds to a single borrower.

It is a process of involving several different lenders in providing various portions of a loan. Loansyndication most often occurs in situations where a borrower requires a large sum of capital that may either be too much for a single lender to provide, or may be outside the scope of a lender's risk exposure levels. Thus, multiple lenders will work together to provide the borrower with the capital needed, at an appropriate rate agreed upon by all the lenders.

7. **Term Loan** - A term loan is a monetary loan that is repaid in regular payments over a set period of time. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. A term loan usually involves an unfixed interest rate that will add additional balance to be repaid.

8. **Mortgage loan** - Amortgage loan, also referred to as a mortgage, is used by purchasers of real property to raise capital to buy real estate; or by existing property owners to raise funds for any

purpose while putting a lien on the property being mortgaged. The loan is "secured" on the borrower's property.

Credit delivery and administration

- Nature /types of credit facility.
- Interest /discount/chargers as applicable.
- Repayment terms.
- Stipulations regarding end use of each facility.
- Additional fees application such as processing fess closing fees or commitment fees.
- Prime security for each credit facility.
- Full description of the collateral securities.
- Details of personal/third party guarantees.

PRICING OF LOANS

It is a process of fixation of interest rates on borrowings of customers with the objective of sustaining the profitability.

- ❖ Every loan has a unique risk profile, which will have to be quantized and build into the price. This implies that, unlike non-financial firms, a single price cannot be fitted to a product line.
- ❖ The price also depends on the profitability of the customer to the bank. Hence, loans to two borrowers with identical risk profile may have to carry different.

Loan price= cost of funds+ servicing costs+ risk premium + desired profit margin.

Models of Loan pricing

1. **Fixed versus floating rates**
   When the interest rates are relatively Stable and the yield curve slopes upward, banks would be willing to lend at fixed interest rates above the rates they pay shorter term liabilities.

2. **Pricing floating loan:**
   Once the benchmark rate is determined, the bank can develop and use prime rate based pricing models .subprime lending is restored to only in exceptional cases .in pricing most loans, a markup over the prime rate stipulated.

3. **Hedging and matched funding:**
   Many borrowers prefer fixed rate loans. If banks have to fixed rate loans in deference to borrower preferences, they attempt to control loss of profits due to interest rate volatility by using Interest Rate Swaps (IRS) or future,or by matched funding.

   An **interest rate swap** (IRS) is a liquid financial derivative instrument in which two parties agree to exchange **interest rate** cash flows, based on a specified notional amount from a fixed **rate** to a floating **rate** (or vice versa) or from one floating **rate** to another.

4. **The pricing leadership model:**

The assumption that the bank knows its costs accurately and can estimate probability of default and recovery rate for each borrower or class of borrowers.

5. **Cost benefit loan pricing:**

It is a practice for many banks to base their loan rates on the base reference rate, the (London Inter-Bank offered rate) LIBOR or the prime rate as bench mark.

- Employ sensitivity analysis to the estimate the total revenue that a loan would generate under different interest rates and charges.
- Estimate the net loanable funds turnover.
- Estimate the before tax yield from the loan by dividing the estimated revenue from the loans by the net amount loanable funds utilized by the borrowers.

CUSTOMER PROFITABILITY ANALYSIS:

1. Identify all the services used by the customer- deposit services, loans availed, payment services, services relating to transfer of funds, custodial services and other fee based services.

2. Identify the cost of providing each service generally unit costs can be derived from the bank's cost accounting system. The bank's services can be bifurcated into credit related and non-related services.

3. Cost estimates for non- credit-related services can be obtained by multiplying the unit cost of each service by the correspondingactivity level.

4. The major portion of costs is in respect of credit –related services. The bank incurs actual cash expenses in interest payment towards the source of funds for the loans, and the costs for credit analysis and execution.

5. The credit – related expenses has a non –cash component-the allocationof default risk expenses.

6. Assess the revenues generated by the relationship with the borrower. The borrower could have deposit balances with the bank, eitheras depositors or by way of compensating balances.

7. Assess the fees based income generated. Fees are generally charges on a per service.

8. Assess the revenue from loans.

FINANCIAL DISTRESS

Financial Distress' is a condition where a company cannot meet or has difficulty paying off its *financial* obligations to its creditors.

Financial distress is a term in corporate *finance* used to indicate a condition when promises to creditors of a company are broken or honored with difficulty. If *financial distress* cannot be relieved, it can lead to bankruptcy.
*(**Bankruptcy** is a legal status of a person or other entity that cannot repay the debts it owes to creditors. In most jurisdictions, **bankruptcy** is imposed by a court order, often initiated by the debtor.)*

It is a tight cash situation in which a business, household, or individual cannot pay the owed amounts on the due date. If prolonged, this situation can force the owing entity into bankruptcy or forced liquidation.

It is compounded by the fact that banks and other financial institutions refuse to lend to those in serious distress. When a firm is under financial distress, the situation frequently sharply reduces its market value, suppliers of goods and services usually insist on COD terms, and large customer may cancel their orders in anticipation of not getting deliveries on time.

It is a stage before bankruptcy where a company's creditors are not being paid or are paid with significant difficulty. While a company can avoid moving from financial distress to bankruptcy, it can be very difficult. Often, financial distress can come with its own costs, such as fees paid to lawyers or the costs of extra interest for late payments.

Financial Distress Prediction Models

A. Altman's Z-score model
B. ZETA score
C. EMS model

A. Altman's Z-score model

Typically, the statistical tolls used to predict financial distress are regression and discriminate analysis. Regression analysis uses past data to forecast values of dependent variables. Discriminate analysis classifies data into predetermined groups by generating an index.

The most popular with bankers and analysts, apart from adhoc models, is the Altman's z-score model. Since it has been thoroughly tested and widely accepted, the model scores over various others that have been subsequently developed and used for predicting bankruptcy

The discriminant function z was found to be:

$Z=1.2x1 + 1.4x2 + 3.3x3 + 0.6x4 + 1.0x5$

Where,

X1 = Working capital /total assets (%)

X2 = Retained earnings /total assets (%)
X3 = EBIT/total assets (%)
X4 = Market value of equity/book value of debt (%)
X5 = Sales of total assets (times)

The firm is classified as 'financially sound' if $Z > 2.99$ and 'financially distressed' or 'bankrupt' if $Z < 1.81$.

The model is based on two important concepts of corporate finance – operating leverage and asset utilization. A high degree of operating leverage implies that a small change in sales results in a relatively large change in sales results in a relatively large change in net operating income. Lenders are aware of pitfalls of financing firms with high operating leverage – they should be convinced that the borrowers can with stand recession or sudden dips in sales. Assets utilization suffers when too many assets are held on the firm's balance sheet, disproportionate to the operating requirements and the sales generated.

However, the Z- score model makes two basic assumptions. One, that firm's equity is publicly traded and second, that it a firm engaged in manufacturing activities.

Hence, it becomes necessary to look for alternate models that predict financial distress in non- manufacturing.

B. Zeta score:

The zeta score enables bank to appraise the risks involved in firms outside the manufacturing sector. It is reported to warning signals 3-5 years prior to bankruptcy.

It consider variables such as

a) Return on assets
b) Earnings stability
c) Debt service
d) Cumulative profitability
e) Current ratio
f) Capitalization and
g) Size of the business as indicated by total intangible assets.

C. EMS (Emerging Market Scoring)**Model**

This model can be applied to both manufacturing and non-manufacturing companies, as well as privately held and publicly owned firms.

EM score= 6.56x1+3.26x2+6.72x3+1.05x4+3.25,

Where x1=working capital/total assets
X2=retained earnings/total assets
X3=operating income/total assets
X4=book value of equity/total liabilities

The EM score is modified based on critical factors such as the firms vulnerability to currency devaluation and its competitive position in industry. The resulting analyst modified rating is compared with the actual bond rating ,if any and other special features such as high collateral or guarantees ,the sovereign rating etc., should be factored in.

ASSET- LIABILITY MANAGEMENT (ALM)

The Asset and Liability management (often abbreviated ALM) is the practice of managing risks that arise due to mismatches between the assets and liabilities.

Asset liability management (ALM) can be defined as the comprehensive and dynamic framework for measuring, monitoring and managing the financial risks associated with changing interest rates, foreign exchange rates and other factors that can affect the organization's liquidity.

ALM relates to management of structure of balance sheet (liabilities and assets) in such a way that the net earnings from interest are maximized within the overall risk-preference (present and future) of the institutions.

Thus the ALM functions includes the tools adopted to mitigating liquidly risk, management of interest rate risk / market risk and trading risk management. In short, ALM is the sum of the financial risk management of any financial institution.

In other words, ALM is all about managing three central risks:

a. Interest Rate Risk
b. Liquidity Risk
c. Foreign currency risk

Through ALM banks try to match the assets and liabilities in terms of Maturities and Interest Rates Sensitivities so as to minimize the interest rate risk and liquidity risk.

Overview of what is Asset-Liability mismatches:

The Assets and Liabilities of the bank's B/Sheet are nothing but future cash inflows & outflows. Under Asset Liability Management i.e. ALM, these inflows & outflows are grouped into different time buckets. Then each bucket of assets is matched with the corresponding bucket of liability.

The differences in each bucket are known as **mismatches.**

Most effective asset-liability management programs have six objectives:

1. Identify financial goals.
2. Identify interest-rate, credit, and liquidity risk.
3. Develop and maintain accurate risk measurement techniques.
4. Integrate asset-liability management into the management process.

5. Evaluate management strategies before implementation.
6. Implement strategies to maximize performance.

Asset- Liability Management Techniques:

ALM is bank specific control mechanism, but it is possible that several banks may employ similar ALM techniques or each bank may use unique system.

1. Gap Analysis

Gap Analysis is a technique of Asset – Liability management. It is used to assess interest rate risk or liquidity risk. It measures at a given point of time the gaps between Rate Sensitive Liabilities (RSL) and Rate Sensitive Assets (RSA) by grouping them into time buckets (0-3 months) according to residual maturity or next re-pricing period, whichever is earlier. An asset or liability is treated as rate sensitive if;

i) Within time bucket under consideration is a cash flow.
ii) The interest rate resets/re-prices contractually during time buckets
iii) Administered rates are changed and
iv) It is contractually pre-payable or withdrawal allowed before contracted maturities.

Thus ; **GAP=RSA-RSL**

GAP Ratio=RSAs/RSL

- Mismatches can be positive or negative
- Positive Mismatch: M.A.>M.L. and vice-versa for Negative Mismatch
- In case of +ve mismatch, excess liquidity can be deployed in money market instruments, creating new assets & investment swaps etc.
- For –ve mismatch, it can be financed from market borrowings(call/Term),Bills rediscounting, repos & deployment of foreign currency converted into rupee.

An Example of Structural Liquidity Statement

	1-14Days	15-28 Days	30 Days-3 Month	3 Mths - 6 Mths	6 Mths - 1Year	1Year - 3 Years	3 Years - 5 Years	Over 5 Years	Total
Capital								200	200
Liab-fixed Int	300	200	200	600	600	300	200	200	2600
Liab-floating Int	350	400	350	450	500	450	450	450	3400
Others	50	50					0	200	300
Total outflow	700	650	550	1050	1100	750	650	1050	6500
Investments	200	150	250	250	300	100	350	900	2500
Loans-fixed Int	50	50	0	100	150	50	100	100	600
Loans - floating	200	150	200	150	150	150	50	50	1100
Loans BPLR Linked	100	150	200	500	350	500	100	100	2000
Others	50	50	0	0	0	0	0	200	300
Total Inflow	600	550	650	1000	950	800	600	1350	6500
Gap	-100	-100	100	-50	-150	50	-50	300	0
Cumulative Gap	-100	-200	-100	-150	-300	-250	-300	0	0
Gap % to Total O	-14.29	-15.38	18.18	-4.76	-13.64	6.67	-7.69	28.57	

The table below gives your idea who does a positive or negative gap would impact on NII in case there is upward or downward movement of interest rates:

Gap	Interest rate Change	Impact on NII
Positive	Increases	Positive
Positive	Decreases	Negative
Negative	Increases	Negative
Negative	Decreases	Positive

2. Duration Gap Analysis:

This is an alternative method for measuring interest-rate risk. This technique examines the sensitivity of the **market value of the financial institution's net worth** to changes in interest rates.

We know that Duration is an important measure of the interest rate sensitivity of assets and liabilities as it takes into account the time of arrival of cash flows and the maturity of assets and liabilities. It is the weighted average time to maturity of all the preset values of cash flows. Duration basically refers to the average life of the asset or the liability.

The larger the value of the duration, the more sensitive is the price of that asset or liability to changes in interest rates. Thus, as per this theory, the bank will be immunized from interest rate risk if the duration gap between assets and the liabilities is zero. The duration model uses the market value of assets and liabilities.

It can be noticed that both gap and duration approaches worked well if assets and liabilities comprised fixed cash flows.

3. Scenario Analysis

Under the scenario analysis of ALM several interest rate scenarios are created during next 5 to 10 years. Such scenarios might specify declining interest rates, rising interests rates, a gradual decrease in rates followed by sudden rise etc.

Different scenarios may specify the behavior of the entire yield curve, so there could be scenarios with flattening yield curve; inverted yield curves etc. 10 to 20 scenarios might be specified to have a holistic view of the scenario analysis.

Next assumptions would be made about the performances of assets and liabilities under each scenario. Assumptions might include prepayment rates on mortgages and surrender rates on insurance products. Assumptions may also be made about the firms' performance. Based upon these assumptions the performance of the firm's balance sheet could be projected under each scenario. If projected performance was poor under specific scenario the ALCO might adjust assets or liabilities to address the indicated exposure.

A short coming of scenario analysis is the fact that it is highly dependent on the choice of scenario. It also requires that many assumptions be made about how specific assets or liabilities will perform under specific scenario.

Asset-Liability Committee - ALCO

A risk-management committee in a bank or other lending institution that generally comprises the senior-management levels of the institution. The ALCO's primary goal is to evaluate, monitor and approve practices relating to risk due to imbalances in the capital structure.

A group within a banking institution responsible for determining borrowing and lending strategy, as it relates to the interest rate environment. The goal of the committee is to maximize profitability.

RISK AND TYPES OF RISKS

Risk can be referred as the chances of having an unexpected or negative outcome. Any action or activity that leads to loss of any type can be termed as risk. There are different types of risks that a firm might face and needs to overcome.

Classified into *Three* types:

Business Risk, Non-Business Risk and Financial Risk.

1. **Business Risk**: These types of risks are taken by business enterprises themselves in order to maximize shareholder value and profits. As for example: Companies undertake high cost risks in marketing to launch new product in order to gain higher sales.

2. **Non- Business Risk**: These types of risks are not under the control of firms. Risks that arise out of political and economic imbalances can be termed as non-business risk.

3. **Financial Risk**: Financial Risk as the term suggests is the risk that involves financial loss to firms. Financial risk generally arises due to instability and losses in the financial market caused by movements in stock prices, currencies, interest rates and more.

RISK MANAGEMENT

Risk management is the continuing process to identify, analyze, evaluate, and treat loss exposures and monitor risk control and financial resources to mitigate the adverse effects of loss.

Loss may result from the following: **Financial** risks such as cost of claims and liability judgments and **Operational** risks such as labor strikes

(The *rule of 72*, the rule of 70 and the rule of 69.3 are methods for estimating an investment's doubling time.By dividing 72 by the annual rate of return, investors can get a rough estimate of how many years it will take for the initial investment to duplicate itself.

Various Risks involved in Banks

a) Interest rate risk
b) Liquidity risk
c) Credit risk
d) Market risk
e) Foreign exchange risk
f) Operational risk
g) Solvency risk
h) Portfolio risk

a) Interest Rate risk

Interest rate is a rate, which is charged or paid for the use of money. An interest rate is often expressed as annual percentage of principal. It is calculated by dividing the amount of interest by amount of principal.

Interest rate risk is defined as the volatility (Changes) in the earnings or value of a financial institution owing to unexpected changes in interest rates.

Interest rate risk will emerge, if interest rate on bank's borrowing increases, than the interest rates on its lending (interest on loan).

Ex.1: A bank that borrows Rs.100 crores at 5% interest for a year and lends the money at 5.5% to a highly rated borrower for 5 years at fixed rate of interest. At the end of the year, if interest rates have been raised, the bank would have to pay a higher rate of interest on the new financing, it reduces its net income and causes for "Interest rate risk".

Ex.2: 80% of Bank C's borrowed loan mature after 3 years and have been borrowed at fixed rate of interest and 80% of Bank C's given short term loan (Lent) to be fully repaid over the next 6 months.

The TWO most common perspectives for assessing a Bank's Interest rate risk& Management:

a) ***The Bank Earnings perspectives that focus on short term*** – It assesses the impact of changes in interest rates on the 'net interest income' (NII- difference between total interest earned from loans & investments and total interest paid on deposits and borrowings) of the bank. – Reduced NII will be threatening the financial stability – so, the bank has to generate non-interest income from fee-based activities.

b) ***The Economic value perspective that looks long term earnings*** –It is like net worth, i.e., expected cash flows on assets and the expected cash flows on liabilities and assessing how fluctuations in interest rate affects the net worth.

b) Liquidity Risk

Liquidity risk is the risk of economic crosses resulting from the sum of all inflow and cash reserve of a financial intermediary (Banks) on a day is not sufficient to meet its outflows on that

day. The assumption of liquidity risk is a natural outcome of the maturity intermediation performed by financial intermediaries.

Liquidity risk is the risk that a company or bank may be unable to meet short term financial demands. This usually occurs due to the inability to convert a security or hard asset and to cash without a loss of capital and or income in the process.

Ex.1: A bank that borrows Rs.100 crores at 5% interest for a year and lends the money at 5.5% to a highly rated borrower for 5 years at fixed rate of interest. At the end of a year, the bank have to repay Rs.100 crores to the depositors, and find new sources of financing for the loan, which still has 4 years of maturity. If the bank is not able to find sources of repayment, it causes for "Liquidity risk".

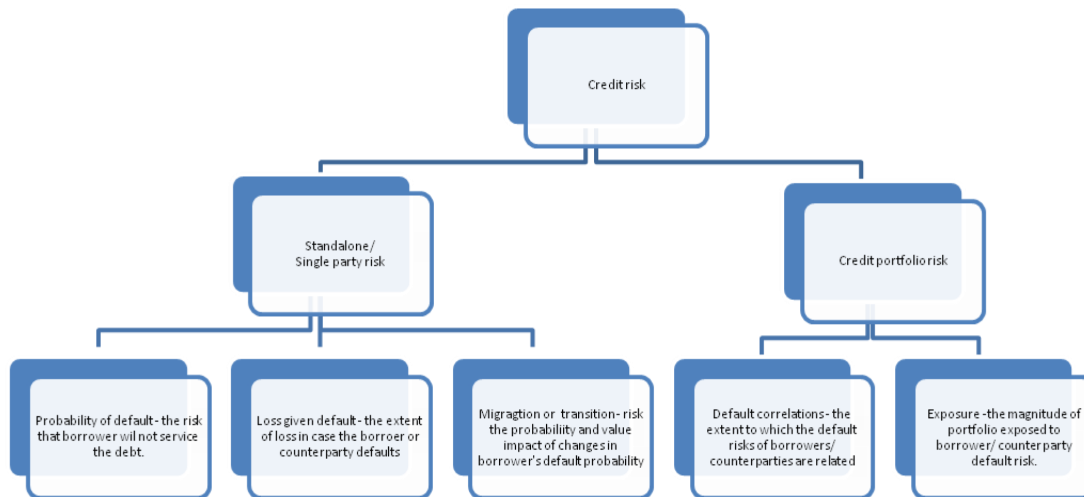
Ex.2: 90% of Bank B's borrowed loan matures within 12 months. Bank B lends 75% of these funds to various schemes, where repayment years and have been borrowed at fixed rate of interest and 80% of Bank C's given short term loan (Lent) to be fully repaid over the next 6 months.

c) Credit Risk

It is defined as the probability that a bank borrower or counter party will fail to meet its obligations in accordance with agreed terms.

Credit risk is the volatility in the value of a financial intermediary's credit portfolio owing to the diminution in credit quality of credit counter parties. Credit risk is the most important risk faced by a bank given the importance of loans and advances in its portfolio the upside of a credit decision for a financial intermediary is a fixed interest income while downside is a loss of interest and principal.

Elements of Credit risk



d) Market Risk:

Market risk is the **risk** that the value of an investment will decrease due to moves in **market** factors. Volatility frequently refers to the standard deviation of the change in value of a financial instrument with a specific time horizon.

Market risk arises from the volatility in values of off and on balance sheet trading position owing to unexpected changes in market price. The focus of market risk is on changes on market price of instruments that from a part of the trading book of a financial intermediary. These market prices could be interest rates equity prices, commodity prices and foreign exchange rates.

VaR (Value at Risk) – it is a measure to quantify market risk. It is defined as the maximum potential loss in the value of a portfolio due to adverse market movements for a given probability.

VaR' A statistical technique used to measure and quantify the level of financial *risk* within a firm or investment portfolio over a specific time frame.

VaR or Value at Risk refers to the maximum expected loss that a bank can suffer over a target horizon, given a certain confidence interval. It enables the calculation of market risk of a portfolio for which no historical data exists. It enables one to calculate the net worth of the organization at any particular point of time so that it is possible to focus on long term risk implications of decisions that have already been taken or that are going to be taken. It is used extensively for measuring the market risk of a portfolio of assets and/or liabilities.

e) Foreign Exchange Risk:

Foreign exchange risk (also known as **FX risk**, **exchange** rate **risk** or **currency risk**) is a financial **risk** that exists when a financial transaction is denominated in a **currency** other than that of the base **currency** of the company.

Foreign exchange risk is defined as the volatility in the earning or financial intermediary caused by unexpected changes in exchange rate like interest rate risk for the banking booking and liquidity risk it also arise from the mismatch between exchange assets and liabilities. If a financial institution has perfectly matched between exchange assets and liabilities, it does not face foreign exchange risk.

a) The risk of an investment's value changing due to changes in currency exchange rates.
b) The risk that an investor will have to close out a long or short position in a foreign currency at a loss due to an adverse movement in exchange rates. Also known as "currency risk" or "exchange-rate risk".

f) Operational risk:

Operation risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events(including legal risk), differ from the expected losses".

It is a risk resulting from breakdowns in internal procedures, people and systems.

g) Solvency risk:

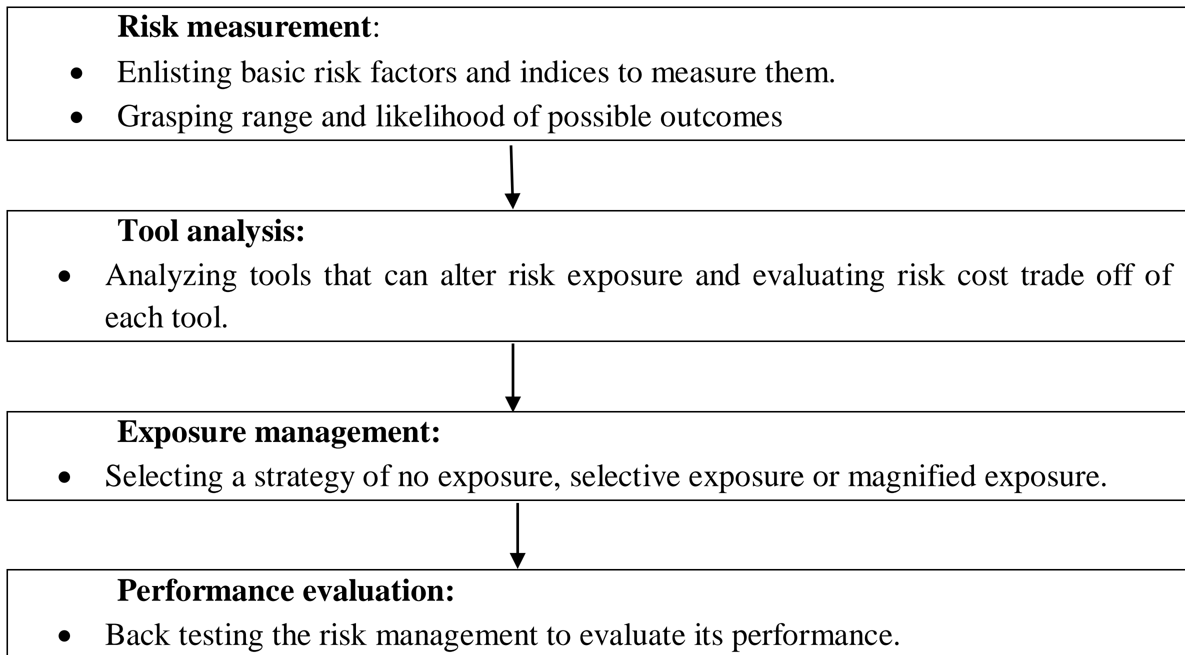
Solvency risk is the risk that an institution cannot meet maturing obligations as they come due for full value (even if it may be able to settle at some unspecified time in the future) even after disposal of its assets.

The levels of credit liquidity, market, interest rate, foreign exchange and operational risks assumed in turn to determine the amount of capital the financial institution needs in order to meet these risks.

Process of Risk Measurement and Mitigation

Risk management process

a) Identifying the loss exposures
b) Analysis the loss exposure
c) Examining the feasibility
d) Selection of appropriate strategy
e) Implementing the strategy
f) Monitoring the results and revising the strategy



M&A's of Banks into Securities market

A **Merger** is a transaction where two firms agree to integrate their operations on a relatively co-equal basis because they have resources and capabilities that together may create a stronger competitive advantage.

A merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new

company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

Ex: Bank of Madura merged with ICICI

ACQUISITION

An ***Acquisition*** is a transaction where one firm buys a controlling or 100 percent interest in another firm with the intent of making the acquired firm a subsidiary business within its portfolio.

When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

Ex: Nedungadi bank amalgamated with Punjab National bank.

While most mergers represent friendly agreements between the two firms, acquisitions sometimes can be classified as unfriendly takeovers. A ***takeover*** is an acquisition—and normally not a merger—where the target firm did not solicit the bid of the acquiring firm and often resists the acquisition (a hostile takeover).

Merger is a result of the decision of two organizations; acquisitions are a takeover of one organization by another. A 'forced' merger or a merger due to survival problems is normally known as an amalgamation.

In 1998 the commercial banking industry worldwide had more volumes of mergers and acquisitions than any other industry. The trend can said to have started in the US in the 1980s.The US banking industry saw more than 7000 mergers between 1980 and 1998.The reasons for the mergers were a new statutory environment that allowed interstate ownership and branching, banks seeking scale economies and geographical diversification and increased competitive pressures.

Reasons account for firms' decisions to Merger/ Acquisition

(1) To increase market power (by becoming larger);
(2) To overcome entry barriers (by acquiring a firm with a position in the target industry);
(3) To reduce cost of new-product development and increase the speed to market entry;
(4) To reduce the risk associated with developing new products internally;
(5) To diversify both firm and managerial risk by increasing the level of diversification;
(6) To reshape the firm's competitive scope; and
(7) To boost learning and the development of new capabilities

Varieties/ Types of Mergers

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- **Horizontal merger** - Two companies that are in direct competition and share the same product lines and markets.

- **Vertical merger**- A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- **Market-extension merger -** Two companies that sell the same products in different markets.
- **Product-extension merger -** Two companies selling different but related products in the same market.
- **Conglomeration** - Two companies that have no common business areas

List of Merged Banks

Anchor Bank	Banks Merged
Punjab National Bank	• Oriental Bank of Commerce • United Bank of India
Canara Bank	• Syndicate Bank
Indian Bank	• Allahabad Bank
Union Bank of India	• Andhra Bank • Corporation Bank
Bank of Baroda	• Dena Bank • Vijaya Bank
State Bank of India	• State Bank of Bikaner and Jaipur • State Bank of Hyderabad • State Bank of Mysore • State Bank of Patiala • State Bank of Travencore • Bharatiya Mahila Bank

* Vijaya Bank and Dena Bank were merged with Bank of Baroda from April 1, 2019

*State Bank of India was merged with its associate banks and Bharatiya Mahila Bank in 2017.

Merits of Public Sector Bank Mergers

- The bank's service delivery will see a huge improvement.
- Mergers enable a large capital base that will aid the acquirer to offer a bigger loan amount.
- Customers of the bank will have a much wider range of products they can choose from in mutual funds, insurance products, loans and deposits.
- The need for recapitalisation from the government will reduce after a merger.
- The bank will have an opportunity to establish technological advancements in their processes.

BA4003 - BANKING AND FINANCIAL SERVICES

UNIT – 3

DEVELOPMENT IN BANKING TECHNOLOGY

PAYMENT SYSTEM IN INDIA

Payment and settlement system in India:

The RBI has spearheaded a vast change in the use of technology for making banking in India safer, more secure, smoother and more efficient. RBI was empowered in 2007 through the enactment of the Payment and Settlement Act, 2007, to regulate and supervise payment and settlement systems in India, formulate relevant policies and provide a legal basis for multilateral netting and settlement finality. To operationalize the Act, RBI framed the 'Board for Regulation and supervision of payment and settlement system regulations, 2008' and Payment and Settlement Systems Regulations, 2008'.

PAYMENT SYSTEM IN INDIA CAN BE BIFURCATED INTO

➢ **Paper based payments**
➢ **Electronic' payment systems.**
➢ **Other payment system**

I. Paper-based payments	II. Electronic payment system	III. Other payment system
➢ Cheques ➢ Drafts ➢ Pay orders	• Electronic Clearing Service (ECS) Credit • Regional ECS (RECS) • Electronic Clearing Service (ECS) Debit • Electronic Funds Transfer (EFT) • National Electronic Funds Transfer (NEFT) System • Real Time Gross Settlement (RTGS) System • Clearing Corporation of India Limited (CCIL)	✓ Pre-paid Payment Systems ✓ Mobile Banking System ✓ ATMs / Point of Sale (POS) Terminals/Online Transactions ✓ National Payments Corporation of India ✓ Oversight of Payment and Settlement Systems

I. PAPER-BASED PAYMENTS

Use of paper-based instruments accounts for nearly 60% of the volume of total non-cash transactions in the country. In value terms, the share is presently around 11%. This share has been steadily decreasing over a period of time and electronic mode gained popularity due to the concerted efforts of Reserve Bank of India to popularize the electronic payment products in preference to cash and cheques.

Since paper based payments occupy an important place in the country, Reserve Bank had introduced Magnetic Ink Character Recognition (MICR) technology for speeding up and bringing in efficiency in processing of cheques.

Later, a separate High Value Clearing was introduced for clearing cheques of value Rupees one lakh and above. This clearing was available at select large centres in the country (since discontinued).

Recent developments in paper-based instruments include launch of Speed Clearing (for local clearance of outstation cheques drawn on core-banking enabled branches of banks), introduction of cheque truncation system (to restrict physical movement of cheques and enable use of images for payment processing), framing CTS-2010 Standards (for enhancing the security features on cheque forms) and the like.

While the overall thrust is to reduce the use of paper for transactions, given the fact that it would take some time to completely move to the electronic mode, the intention is to reduce the movement of paper – both for local and outstation clearance of cheques.

II. E-PAYMENT: ELECTRONIC PAYMENTS

- **a.** Electronic Clearing Service (ECS) Credit
- **b.** Regional ECS (RECS)
- **c.** Electronic Clearing Service (ECS) Debit
- **d.** Electronic Funds Transfer (EFT)
- **e.** National Electronic Funds Transfer (NEFT) System
- **f.** Real Time Gross Settlement (RTGS) System
- **g.** Clearing Corporation of India Limited (CCIL)

a. Electronic Clearing Service (ECS) Credit

The Bank introduced the ECS (Credit) scheme during the 1990s to handle bulk and repetitive payment requirements (like salary, interest, dividend payments) of corporates and other institutions. ECS (Credit) facilitates customer accounts to be credited on the specified value date and is presently available at all major cities in the country.

During September 2008, the Bank launched a new service known as National Electronic Clearing Service (NECS), at National Clearing Cell (NCC), Mumbai. NECS (Credit) facilitates multiple credits to beneficiary accounts with destination branches across the country against a single debit of the account of the sponsor bank. The system has a pan-India characteristic and leverages on Core Banking Solutions (CBS) of member banks, facilitating all CBS bank branches to participate in the system, irrespective of their location across the country.

b. Regional ECS (RECS)

Next to NECS, RECS has been launched during the year 2009.RECS, a miniature of the NECS is confined to the bank branches within the jurisdiction of a Regional office of RBI. Under the system, the sponsor bank will upload the validated data through the Secured Web Server of RBI containing credit/debit instructions to the customers of CBS enabled bank branches spread across the Jurisdiction of the Regional office of RBI. T

The RECS centre will process the data, arrive at the settlement, generate destination bank wise data/reports and make available the data/reports through secured web-server to facilitate the destination bank branches to afford credit/debit to the accounts of beneficiaries by leveraging the CBS technology put in place by the bank. Presently RECS is available in Ahmedabad, Bengaluru, Chennai and Kolkata

c. Electronic Clearing Service (ECS) Debit

The ECS (Debit) Scheme was introduced by RBI to provide a faster method of effecting periodic and repetitive collections of utility companies. ECS (Debit) facilitates consumers / subscribers of utility companies to make routine and repetitive payments by 'mandating' bank branches to debit their accounts and pass on the money to the companies. This tremendously minimizes use of paper instruments apart from improving process efficiency and customer satisfaction. There is no limit as to the minimum or maximum amount of payment. This is also available across major cities in the country.

d. Electronic Funds Transfer (EFT)

This retail funds transfer system introduced in the late 1990s enabled an account holder of a bank to electronically transfer funds to another account holder with any other participating bank. Available across 15 major centers in the country, this system is no longer available for use by the general public, for whose benefit a feature-rich and more efficient system is now in place, which is the National Electronic Funds Transfer (NEFT) system.

e. National Electronic Funds Transfer (NEFT) System

In November 2005, a more secure system was introduced for facilitating one-to-one funds transfer requirements of individuals / corporate. Available across a longer time window, the NEFT system provides for batch settlements at hourly intervals, thus enabling near real-time transfer of funds. Certain other unique features viz. accepting cash for originating transactions, initiating transfer requests without any minimum or maximum amount limitations, facilitating

one-way transfers to Nepal, receiving confirmation of the date / time of credit to the account of the beneficiaries, etc., are available in the system.

f. Real Time Gross Settlement (RTGS) System

RTGS is a funds transfer systems where transfer of money takes place from one bank to another on a "real time" and on "gross" basis. Settlement in "real time" means payment transaction is not subjected to any waiting period. "Gross settlement" means the transaction is settled on one to one basis without bunching or netting with any other transaction. Once processed, payments are final and irrevocable. This was introduced in 2004 and settles all inter-bank payments and customer transactions above 2 lakhs.

g. Clearing Corporation of India Limited (CCIL)

CCIL was set up in April 2001 by banks, financial institutions and primary dealers, to function as an industry service organisation for clearing and settlement of trades in money market, government securities and foreign exchange markets.

The Clearing Corporation plays the crucial role of a Central Counter Party (CCP) in the government securities, USD –INR forex exchange (both spot and forward segments) and Collaterised Borrowing and Lending Obligation (CBLO) markets. CCIL plays the role of a central counterparty whereby, the contract between buyer and seller gets replaced by two new contracts - between CCIL and each of the two parties. This process is known as ‘Novation’. Through novation, the counterparty credit risk between the buyer and seller is eliminated with CCIL subsuming all counterparty and credit risks. In order to minimize these risks, that it exposes itself to, CCIL follows specific risk management practices which are as per international best practices. In addition to the guaranteed settlement, CCIL also provides non-guaranteed settlement services for National Financial Switch (Inter bank ATM transactions) and for rupee derivatives such as Interest Rate Swaps.

CCIL is also providing a reporting platform and acts as a repository for Over the Counter (OTC) products.

III. OTHER PAYMENT SYSTEMS

a. **Pre-paid Payment Systems**
b. **Mobile Banking System**
c. **ATMs / Point of Sale (POS) Terminals / Online Transactions**
d. **National Payments Corporation of India**
e. **Oversight of Payment and Settlement Systems**

a. Pre-paid Payment Systems

Pre-paid instruments are payment instruments that facilitate purchase of goods and services against the value stored on these instruments. The value stored on such instruments represents the value paid for by the holders by cash, by debit to a bank account, or by credit card. The pre-

paid payment instruments can be issued in the form of smart cards, magnetic stripe cards, internet accounts, internet wallets, mobile accounts, mobile wallets, paper vouchers, etc.

Subsequent to the notification of the PSS Act, policy guidelines for issuance and operation of prepaid instruments in India were issued in the public interest to regulate the issue of prepaid payment instruments in the country.

The use of pre-paid payment instruments for cross border transactions has not been permitted, except for the payment instruments approved under Foreign Exchange Management Act,1999 (FEMA).

b. Mobile Banking System

Mobile phones as a medium for providing banking services have been attaining increased importance. Reserve Bank brought out a set of operating guidelines on mobile banking for banks in October 2008, according to which only banks which are licensed and supervised in India and have a physical presence in India are permitted to offer mobile banking after obtaining necessary permission from Reserve Bank. The guidelines focus on systems for security and inter-bank transfer arrangements through Reserve Bank's authorized systems. On the technology front the objective is to enable the development of inter-operable standards so as to facilitate funds transfer from one account to any other account in the same or any other bank on a real time basis irrespective of the mobile network a customer has subscribed to.

c. ATMs / Point of Sale (POS) Terminals / Online Transactions

Presently, there are over 61,000 ATMs in India. Savings Bank customers can withdraw cash from any bank terminal up to 5 times in a month without being charged for the same. To address the customer service issues arising out of failed ATM transactions where the customer's account gets debited without actual disbursal of cash, the Reserve Bank has mandated re-crediting of such failed transactions within 12 working day and mandated compensation for delays beyond the stipulated period. Furthermore, a standardized template has been prescribed for displaying at all ATM locations to facilitate lodging of complaints by customers.

There are over **05 lakh** POS terminals in the country, which enable customers to make payments for purchases of goods and services by means of credit/debit cards. To facilitate customer convenience the Bank has also permitted cash withdrawal using debit cards issued by the banks at PoS terminals.

The PoS for accepting card payments also include online payment gateways. This facility is used for enabling online payments for goods and services. The online payment are enabled through own payment gateways or third party service providers called intermediaries. In payment transactions involving intermediaries, these intermediaries act as the initial recipient of payments and distribute the payment to merchants. In such transactions, the customers are exposed to the uncertainty of payment as most merchants treat the payments as final on receipt from the intermediaries. In this regard safeguard the interests of customers and to ensure that the

payments made by them using Electronic/Online Payment modes are duly accounted for by intermediaries receiving such payments, directions were issued in November 2009. Directions require that the funds received from customers for such transactions need to be maintained in an internal account of a bank and the intermediary should not have access to the same.

Further, to reduce the risks arising out of the use of credit/debit cards over internet/IVR (technically referred to as card not present (CNP) transactions), Reserve Bank mandated that all CNP transactions should be additionally authenticated based on information not available on the card and an online alert should be sent to the cardholders for such transactions.

d. National Payments Corporation of India

The Reserve Bank encouraged the setting up of National Payments Corporation of India (NPCI) to act as an umbrella organisation for operating various Retail Payment Systems (RPS) in India. NPCI became functional in early 2009. NPCI has taken over National Financial Switch (NFS) from Institute for Development and Research in Banking Technology (IDRBT). NPCI is expected to bring greater efficiency by way of uniformity and standardization in retail payments and expanding and extending the reach of both existing and innovative payment products for greater customer convenience.

e. Oversight of Payment and Settlement Systems

Oversight of the payment and settlement systems is a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change. By overseeing payment and settlement systems, central banks help to maintain systemic stability and reduce systemic risk, and to maintain public confidence in payment and settlement systems.

The Payment and Settlement Systems Act, 2007 and the Payment and Settlement Systems Regulations, 2008 framed there under, provide the necessary statutory backing to the Reserve Bank of India for undertaking the Oversight function over the payment and settlement systems in the country.

E-BANKING AND ITS ADVANTAGES

Meaning of E-banking

E-banking refers to the use of technology which allows customers to perform banking transactions electronically without visiting a brick and mortar institution. On-line means direct linking of an operation or equipment to a computer system, so that any stimulus provided by that operation or equipment is immediately accepted by the computer system.

Electronic services allow a bank's customers and other stakeholders to interact and transact with the bank seamlessly through online banking, phone banking and tele-banking.

Other services offered under e-banking include electronic fund transfer, electronic clearing service and electronic payment media including the credit card, debit card and smart card.

On-line banking helps consumers to overcome the limitations of place and time as they can bank anywhere, anytime as these services are available 24 hours, 365 days a year without any physical limitations of space like a specific bank branch, city or region. They also bypass the paper level based aspect of traditional banking.

Benefits of Electronic Banking

A. FOR BANKS	**B. FOR CUSTOMER**
1. **Price**	**1. Convenience**
2. Customer base	**2. Cost**
3. Efficiency	**3. Speed**
4. **Image**	**4. Communication**
5. **Customer satisfaction**	**5. Environmental**
6. Competitiveness	
7. **Promoting services**	

A. Benefit for Banks

1. Price

In the long run, a bank can reduce expenses by not paying for tellers or for managing branches. Also it is cheaper to make transactions over the Internet.

2. Customer base

The internet allows banks to reach new market and high net worth individual, because there are no geographical boundaries with the internet. The internet also provides a level playing field for small banks who want to add to their customer base.

3. Efficiency

Banks can become more efficient by providing internet access for their customers. The internet provides the bank with an almost paperless system.

Customer service and satisfaction: banking on the internet not only allows the customer to access full range of available services but it also provide some services not offered at any of the branches. The customers can print information, forms and applications via the internet and search for information efficiently instead of waiting in line and asking bank employees. With better and faster options, a bank will surely be able to create better customer relations and satisfaction.

4. Image

A bank seems more state-of-the-art to a customer if they offer-internet access. A person may not want to use e-banking but having the service available gives a person the feeling that the bank is on the cutting edge.

5. **Customer satisfaction**
6. **Competitiveness**
7. **Promoting services**

B. Benefit for Customers

1. **Convenience :** 24 hours a day, seven days a week
2. **Cost :** Reducing transfer fees
3. **Speed:** Faster circulation of assets
4. **Competitiveness:** Fostering competition in financial market
5. **Communication:** Communicate easily
6. **Environmental:** Abolishing the uses of paper
7. **Others :** Offering one-stop-shop solutions

PLASTIC MONEY

CREDIT CARDS

Credit cards started off as a type of payment cards issued by some merchants for the convenience of their customers. It is believed that the first such card was issued by sears in 1910, which was quickly emulated by other retailers who issued cards containing vital information about the customer, which was recorded when the card was put through a processing device. The popular 'Diner's club' was introduced in 1947 to be used in multiple restaurants that were willing to participate in the scheme. It is to be noted here that these cards had to be paid in full each month, and, therefore, had very little 'credit' or 'loan' component to them.

Today, credit cards are synonymous with a form of short term, resolving credit to the cardholder. As pointed out in the chapter on bank lending, a revolving credit replenishes automatically when loan installments are met.

For typical card accounts in the form of revolving credit, the cardholders are billed monthly for purchase made with the credit card. Every month, cardholders have the option of paying back the entire outstanding amount on the credit card, or the minimum payment stipulated, say 2 per cent or 3 per cent of the outstanding balance. Typically, a grace period of about a month or more is granted, during which is no interest will be charged on the 'loan'. Cardholders who pay the minimum amount every month are considered current on their account.

If one payment is not made on the time, the account would be considered delinquent after a period. Hence, it is evident that credit card is very similar to a loan account with a bank.

Credit cards can be issued through various channels. The most common are 'general purpose' cards, such as Visa or Master Card. These are accepted by most merchants/retailers. It is also the practice of individual banks to issue co-branded cards with Visa or Master network.

Credit cards can be broadly classified into three types. These are as follows:

1. **Bank cards**,

   Such as MasterCard, Visa, Maestro, etc. This type of cards are sponsored by individual banks and considered all-purpose cards. Each bank decides credit limits, annual fees, terms and conditions.

2. **Travel and entertainment cards**

   Such as American Express or Dimer's Club. These types of cards are used by people for travel and entertainment expenses. In many cases, unlike credit cards, cardholders are expected to pay the balance outstanding in full every month. Hence, while credit cards permits users to carry balances over several months, provided the minimum payment is made every month, 'travel and entertainment' cardholders will have to pay back the 'credit' in 1 or 2 months at most.

3. **Company or Retail Store cards**

   Such as Wal-Mart, Reliance, BP, Shell or Mobil. These types of cards are used in the retail stores or gas station. These are issuer-specific and cannot be used for all purposes as can be done for bank-issued credit cards.

The Parties to Credit Card Transactions

The following are the principle players in credit card transactions:

- Card issuers
- Card holders/users
- Members establishments (MEs)
- Member affiliates (MAs)
- Clearing Agencies
- Credit card affiliates

The role of each party in credit card transactions is described briefly in the following paragraphs:

- **Card issuers:** card issuers are predominantly banks. Almost all banks today offer credit card services to retail customers. Credit card business is attractive to banks because of the potentially high returns. For example, credit period of about 45 days, but charge at rate of say 2.5 per cent per month on the entire outstanding amount at the end of the credit period. Thus, on a single purchase through a credit card, assuming the customer does not pay within the credit period, the bank can earn up to 4.5-5 per cent per month, which is a significant 55-60 per cent per year. From our discussion on corporate lending in earlier chapters, it is clear that banks do not earn such high returns on other types of advances.

  Of course, credit cards also mean cost to the bank, the cost of marketing the credit cards, making of the card with tamper proof features, credit information, processing, investigation, follow up to recover receivables, bad debit losses at the other end of the spectrum that can be quite high.

- **Card holders**: The cardholders or users could be individuals or business entities. As for other types of lending, the amount that can be drawn against the credit card is based on creditworthiness criteria. After his account gets approved by the credit issuer bank, the customer is issued a credit card, with which the customer would be able to make purchase from merchants accepting that credit card up to a pre-established credit limit.

- **Member Establishments (MEs):** These are the establishments/ merchants who accept valid credit cards as payment for goods/services, in place of cash. MEs can be large retail establishments, restaurants, hospitals, gas filling stations, travel agencies, in short, any entity which van generates a good volume of business to justify usage of credit cards. As mentioned earlier, MEs will have to pay a 'fee' in the form of commission for every credit card payment they accept. Sometimes, this fee is passed on to the cardholder, which implies that the cardholder pays more for usage of the card.

- **Member Affiliates (MAs):** A large organization that wishes to issue credit cards in its name without investing in the elaborate infrastructure for servicing credit cards may opt for the 'affiliate' route. The affiliate enters into an agreement with a card issuer, who authorizes the affiliate to issue credit card in its name, along with that of the original issuer. Many large kind of affiliate arrangement could happen between banks as well.

- **Clearing agencies or card associations**: Master card international and Visa international are the two leading international card issuers who also act as clearing agencies. The card issuers associate themselves with one of these agencies to enable the cardholder of one affiliate to use the card at the member establishment of another affiliate. They are also called 'credit and affiliates' when the logos of both the clearing agency and the issuer are embossed on the face of the card.

Credit Card Issuers Make Money as follows

There are three main sources of income for credit card issuers, fees paid by MEs, interest on cardholder balances and other fees charged to cardholders. A visa or MasterCard affiliation involves more than a simple transaction between customer and the ME, while the acquiring bank would take Rs.0.50. Apart from interest payable by the cardholder on unpaid balances on the credit card, the issuing bank earns from other charges, such as annual charges, penalty fees for late payments, over the limit transactions, fees for such advances and so on.

The marketing and operating expenses increase as card issuers compete to differentiate themselves in the market. It is not uncommon to see and own cards with additional benefits such as insurance coverage, purchase protection, rewards or points-based programmes and cash back offers.

Credit cards-benefits / advantages

Benefits accrue to customers	**Benefits to merchants**:
a) Deferred payment of bills b) Revolving credit c) Rewards from card issuers	a) Immediate payment b) Assured payment **c)** Increased customer spending

DEBIT CARDS AND OTHER PAYMENTS

To a customer credit and debit cards may look-alikes. Both are almost the same size, provide the same payment function and may also carry the master/visa card logo that makes them acceptable at merchant establishments where credit cards are accepted. But debit cards are quite different from credit cards.

If credit cards advocate ‘pay later’, debit cards signify ‘pay now’. The debit card is a product through which the customer’s own account with the card issuer is debited immediately to the extent of transaction value. Further, the debit card does not allow the customer to ‘borrow’, nor does it provide ‘resolving credit’.

The debit card programme requires a ‘POS’ terminal at the member establishment. The debit card, behind which there is a magnetic strip, is inserted into the machine by the customer at the time of billing for purchases made. The merchant keys in the transaction amount.

There are two types of debit system followed at the point of payment-one a ‘signature-based’ card, where the customer swipes he card and signs the sales receipt, and the second a ‘PIN-based’ transaction.

The PIN is known only to the cardholder and the issuing bank. Once the PIN is entered, the machine places an automatic call to the bank, checks the balance in the customer’s account, and reduces the balance to the extent of the transaction value. The merchant’s account is credited for the transaction value.

Benefits/ advantages to customers

The following are the **benefits enjoyed by the customers**:

- **Payment convenience and safety.**
  The customer does not have to carry a cheque - book or large sums of cash.
- **Wide acceptance.**
  Debit cards are more widely accepted than cheques. They are suited for online shopping and travel.
- **Easier qualification.**
  Since debit cards use the customer’s own money, not his credit, they are often easier to get than credit cards.

Benefits/ Advantages to merchants

- **Fast approvals:** Authorized transactions in seconds.
- **Fraud prevention:** Purchase amounts are 100 percent authorized at the POS, reducing losses due to fraudulent checks
- **Increased sales:** Statistics show the average ticket sale is increased with debit acceptance.
- **Minimum investment and charges:** Involves adding a low-cost PIN pad that works with existing equipment, merchants prefer PIN-based debit card since the charges are lower.

- **Security:** Online debit transactions are encrypted to protect the integrity of the cardholder's personal banking information.
- **Cash management:** Funds are available sooner than with personal cheques. Debit transactions are funded within 2-3 days of batch settlement.

OTHER PAYMENT CHANNEL/PRODUCTS

1) Automated teller machines (ATM)

Despite the development of electronic payment systems, customers still prefer cash for various transactions. Cash delivery is increasingly being done on the huge base of automated teller machines (ATMs), which are being increasingly networked together to permit customers to collect cash from different banks as well as in other countries. ATM and credit card networks are linked in, and VISA and MasterCard holders have long enjoyed the facility to draw cash from ATMs. ATM networks are increasingly being developed by non-banking organizations as well.

As ATMs gain popularity, banks in India have started looking at alternative users for the investment made. Some banks have tapped the vast potential of ATM structures to provide innovative and value-added services to customers, such as fund transfers, bill payment services, mobile phone recharge and soon.

2) Mobile banking

The rapid spread of the 'mobile phone' era has helped banks use this mode for transactions. Mobile banking can be used for small-value payments at relatively lower costs, and, therefore is being used in many developing countries as a delivery channel to facilitate financial inclusion. In countries where mobile banking has been introduced, there are two distinct models that can be operated the bank-led and telecom company –led models.

3) Prepaid payment instruments

These are payment instruments such as smart cards, magnetic strip cards, internet accounts, internet wallets, mobile accounts, Mobile wallets and so on, where value is stored in advance to be used when required. The 'value stored' is the value paid by cash, debit or credit card by the instrument holder. Purchase of goods and services is made against the stored value in the prepaid instruments. Hence, these instruments serve as a convenient and relatively risk-free mode of payment in lieu of cash, and for e-payments through internet/mobile.

FORECASTING CASH DEMAND IN ATM

i.	Location of the branch / ATM.
ii.	Number of current accounts.
iii.	Resident accounts and their age profile (for example, some banks have a captive audience of pension holders) etc.
iv.	Number of salary accounts.
v.	Seasonal factors including weekends, festivities etc.s
vi.	Total deposits of the branches
vii.	Total advances (amount lent to the customers)
viii.	Branch location.
ix.	Number of salary account holdings.
x.	Corporate accounts if any
xi.	Total receipts / payments of the branch in the last 3 months.

Process of Cash Demand Forecasting

There are **four steps** in any market forecast undertaken by an organization:

a. Defining the market for the product / basket of products.
b. Dividing total industry demand into its main components.
c. Forecasting the drivers of demand in each segment and projecting how they are likely to change.
d. Conducting sensitivity analysis to understand the most critical assumptions and to gauge risks to the baseline forecast.

The selection of a FORECASTING METHOD depends on the following factors –

➢	The context of the forecast.
➢	Relevance and availability of historical data.
➢	Time period to be forecasted.
➢	Degree of accuracy desirable.
➢	Cost benefit or v
➢	Value of the forecast to the bank.
➢	Time available for making the analysis.

The following are the factors that are kept in mind while forecasting tools for demand management of cash is decided for the branches as well as the ATMs:

i. There is no stock out situation in any of the branches as well as the ATMs.
ii. There is not much of idle cash lying since the opportunity cost of holding cash is quite high.
iii. The cost of delivering cash to the branches and ATMs through the outsourced agents is minimized.
iv. The lead time to deliver cash is minimized.

v. The architecture of the supply chain also becomes an endogenous variable since it has a direct relationship with the efficiency / responsiveness of the supply chain**.**

Information Technology Act 2000

IT Act 2000 aims to provide the legal infrastructure for e-commerce in India, enables the conclusion of contracts and the creation of rights and obligations through the electronic medium. The Cyber laws are contained in the IT act 2000 & 2002.

Objectives of the Act

a. To grant legal recognition for transactions carried out by e-commerce
b. To give legal recognition to digital signature for authentication
c. To facilitate electronic filing of documents with Govt. departments
d. To facilitate electronic storage of data
e. To facilitate and give legal sanction to Electronic fund transfer
f. To give legal recognition for keeping books of accounts by bankers in electronic form

Digital signature

It means authentication of any electronic record by a subscriber by means of an electronic method or procedure.

CYBER LAW

Cyber law: It is a Law amended to prevent and regulate computer related crimes and offences.

Prevention of Computer crimes/ cyber crimes

a) By educating everyone
- Understand how technology can be used to help & hurt
- Think about computer pirate etc.

b) By practicing safe computing
- Always ask – who has access to my log in address

List of Cyber crimes and Cyber offences (U/s.65 to 78)

1. **Tampering with computer source documents** – conceal/ destroy/ alter any computer source code used for a computer programme/ system/ network.

   If any person knowingly or intentionally conceals, destroys or alters computer source code used in computer programmes or computer is an offence (Punishment upto 3 years imprisonment or fine of Rs.2,00,000 or both).

2. **Hacking with computer system** – Unauthorised access to computer network and damaging information in PC.

   * Hacking with company: Breaking in to Computer system or Network

3. Publishing of information which is obscene (Highly offensive) in electronic form.

- Punishment for sending offensive messages through communication service, etc.

Any person sends, by means of a computer resource or a communication device,

- Any information has menacing (threatening) character

-Any information which is false, but to causing annoyance (irritate), inconvenience, danger, insult, criminal intimidation, injury, etc.

4. **Mis-representation** – Mis representation of any package which is authorized or licensed
5. **Financial crimes** – It includes cheating, credit card frauds etc.,
6. **Cyber pornography** – That is representation of sexual activities
7. **Sale of illegal articles** – Sale of any illegal articles by using computers, i.e., Sale of drugs, weapons and wild life. Eg.: In India 'cocaine' was sold in the name of 'honey'.
8. **On-line gambling**
9. **Intellectual property crimes** – Software piracy, trade mark violations, theft of computer source code.
10. **Forgery** – Forgery of currency notes, postage or revenue stamps or mark sheets by using computer/ printer/ scanners
11. **Cyber defamation** – Publishing false/ wrong statement that damaging to a person's reputation.
12. **Cyber stalking** – Following a person's movement, by e-mail, that is bombarding the victim
13. **E-mail bombing** – Sending threatening e-mail and e-mail frauds.
14. **Data diddling** (cheating) – Altering raw data just before it is processed by a company and changing it back after the processing is completed.
15. **Virus/ worm attacks**
16. **Internet time thefts**
17. Web jacking – forcefully takes control of a website
18. Theft of computer system (PCs)

Cyber law Offences

1. Punishment for dishonestly receiving stolen computer resource or communication device

2. Punishment of identity theft: Whoever, fraudulently or dishonestly makes use of the electronic signature, password or any other unique identification code of other person, shall be punishable.

3. Punishment for cheating by personating by using computer resource: Whoever, by means of any communication device cheats by personating shall be punishable.

4. Punishment for violation of privacy: Whoever, intentionally or knowingly captures (images), published/ transmits the image of a private area of any person and violating the privacy of that other person.

5. Punishment for cyber terrorism

a. With intent to threaten the unity, integrity, security or sovereignty of India or to strike terror in the people

b. Usage of any information, data or computer data base against the interest of the sovereignty and integrity of India.

6. Punishment for publishing or transmitting obscene material in electronic form

7. Punishment for publishing or transmitting of material containing sexually explicit act, etc.

8. Punishment for publishing or transmitting of material depicting children in sexually explicit act, etc., in electronic form

Create text digital images, collects, seeks, browses, downloads, advertises, promotes, exchanges or distributes material in any electronic form depicting children in obscene or indecent or sexually explicit manner and facilitating abusing children online, etc.

9. Preservation and retention of information by intermediaries

10. Penalty for misrepresentation

11. Penalty for breach of confidentiality and privacy

12. Punishment for disclosure of information in breach of lawful contract

13. Confiscation (deletion).

Cyber Regulations Appellate Tribunal

1. Establishment : By Central government by notification in official gazette
2. Composition of Tribunal : One person only (Presiding officer)
3. Qualification of Presiding officer
   – Judge of High court or
   - Member of Indian legal services in I-Grade services for at least 3 years
4. Term of office of Presiding officer – 5 years or Until he attains the age of 65 years
5. Staff of Tribunal : All the required staff are provided by Central government and their salary, allowances, etc. also provided by the Central Govt.
6. Functions
   - Summoning & enforcing the attendance of any person and examining him
   - Requiring production of documents/ electronic records
   - Receiving evidence
   - Reviewing its decision
   - Dismissing any application

SECURITY ISSUES IN E-BANKING

It is evident that e-banking is here to stay. However, the advent of high technology has also brought with if new operational risks in the form of security risks. The safety of banks, the integrity of the country's payment and settlement systems, and the trust that customers impose in the safety of the system are all intertwined to ultimately contribute to financial stability. The challenge for the future will be to identify and address risks to banking safety and security without hampering technological innovation in banking.

Internet-banking has evolved into a mass market product-an essential service whose quality can affect the customer's loyalty to and satisfaction with their bank. And, not surprisingly, it is internet-banking that is posing the gravest risk to banks' viability and sustenance. Hackers and fraudsters have realized the immense potential of internet-banking to give them ill-gotten monetary gains.

Therefore, as new technologies evolve to make banking faster and more convenient for customers, the concerns about e-payment security have increased. The 'conventional' risks of unauthorized access, identify theft or network attacks have been exacerbated by 'contemporary, threats-phishing and pharming, spear phishing, carding and skimming, crime ware and spyware, money laundering, mules, scams, spams, Nigerian advance fee fraud and skill counting.

MAJOR SECURITY ISSUES IN E-BANKING

1. Identify thefts
2. Carding/skimming
3. Phishing
   - Email phishing
   - Pharming
   - Spear phishing
   - Plash phishing
   - Vishing (voice phishing
   - Man in middle attacks (phishing in sections)
   - Men in browser attacks

4. Mules

1. Identify thefts

In the virtual world, a person's identity is defined by the user name, passwords or account names. Identity theft is the misuse of personal data or documents in order to impersonate another individual to carry out illegal or fraudulent activities, e.g., to abuse the victim's banking facilities or other assets. Especially affected are popular transaction types, such as card transactions at ATMs, online banking transactions or the use of credit card numbers for internet payment.

2. **Carding/skimming**: carding sites can be found on the internet, where fraudsters buy and sell access to bank accounts, stolen card numbers, dumps from magnetic strips and even personal profiles.

   'Skimming' constitutes the unnoticed duplication of electronic data from a payment card. A copying device is installed in front of the original card slot of an ATM, which transcribes the information from the magnetic stripe on a card inserted by a customer. Sometimes these devices could be a camera or a fake touch pad to duplicate the keystrokes used for password entry.

   The vital information obtained by these methods enables fraudsters to easily create duplicate cards and withdraw money from the accounts in question. Instances of skimming can also occur at cash registers.
3. **Phishing:** 'phishing' is a famous word these days-signifying fraudulent capture and recording of customer's security details, to be used later for committing fraud. It originates from the analogy that internet fraudsters are using email lures to 'fish' for passwords and financial data from myriads of internet users.

<u>**Phishing can take on several forms such as following**</u>:

- **Email phishing** signifies creation of email messages and web pages that exactly resemble existing sites in order to deceive users to part with financial, personal or password data to fraudsters.
- **Pharming** is the use of malware/ spyware to redirect internet users from genuine web sites to fraudulent ones. It carries out modifications in the name resolution system, such that when a user opens the web site of his bank, it actually takes the user to the fraudulent web site.
- **Spear phishing** is a highly targeted phishing attack that focuses on a whole group such as employees of a certain firm, government agency or organization. The message would appear as though it is generated by the employer, asking for updating of passwords or any other personal information. Spear phishing could, therefore, gain access and wreak havoc on an entire company's computer system.
- **Plash phishing** uses macromedia flash to build an entire web site. The use of flash is intended to make it more difficult to determine whether or not the page is malicious, and could also bypass ant phishing toolbars.
- **Vishing (voice phishing)** may being with an email or telephone call. The email warns that the user's bank account has been cyber attacked and, therefore the user has to call certain telephone number, which will ask for the account number and other details. The phone call version purports to be even more authentic. The caller already knows the user's credit card number and asks for the valuable 3-digit code at the back of the card. Such calls can be set up quickly and automatically by voice over internet protocols (VoIP).
- **Man in middle attacks (phishing in sections**) is a rapidly growing threat to online banking security. Fake web sites are set up to closely replicate the bank's authentic web sites. The bank customer receives an email purportedly from the bank, asking the customer to click on a link provided on the bank 'web site'. Once this is done, the customer is automatically taken to the fake bank web site. In another approach, the

customer’s internet connection is already tampered with; hence, when the customer tries to visit the genuine bank web site, he invariably gets connected to the fake web site

- **Men in browser attacks** have reached an even higher level of sophistication. In these cases, rather than intercepting communication between the customer’s computer and the bank web site, the malicious software (malware) installed on the customer’s computer intercepts communication between the customer and his web browser.

4. **Mules ‘mules’ are individuals ‘recruited’** over the internet with the sole purpose of being intermediaries for illegally acquired funds. These funds could have been acquired through methods such as phishing and other types of scams. The name ‘mule’ is suggestive of the transport method that smugglers are believed to have adopted for moving their illegally acquired goods.

   Mules earn sizeable sums of money- deducting 5 percent to 10 percent of the transferred amount as fee for their ‘services’. The money is transferred through anonymous transfer services, such as Western Union or e-gold.

   Contrary to popular belief, mules are not innocent people pricked into illegal business. They are typically mercenary volunteers with scant respect for the law - and for tis very reason, they are turning ‘professionals’.

BA4003- BANKING AND FINANCIAL SERVICES

UNIT – 4: ASSET BASED FINANCIAL SERVICES

Non-Banking Financial Companies

A Non-Banking Financial Company (NBFC) is a company a) registered under the Companies Act, 1956, b) its principal business is lending, investments in various types of shares/stocks/bonds/debentures/securities, leasing, hire-purchase, insurance business, chit business, and c) its principal business is receiving deposits under any scheme or arrangement in one lump sum or in installments.

However, a Non-Banking Financial Company does not include any institution whose principal business is agricultural activity, industrial activity, trading activity or sale/purchase/construction of immovable property.

a. **Mutual fund companies: Mutual Fund**. A **mutual fund** is a **company** that brings together money from many people and invests it in stocks, bonds or other assets. The combined holdings of stocks, bonds or other assets the **fund** owns are known as its portfolio.

b. **Stock Broking Companies:** A **stockbroker** is a regulated professional individual, usually associated with a brokerage firm or **broker**-dealer, who buys and sells **stocks** and other securities for both retail and institutional clients, through a **stock** exchange or over the counter, in return for a fee or commission.

c. **Leasing companies:** The **leasing company** is the legal owner of the goods, but ownership is effectively conveyed to the lessee, who incurs all benefits, costs, and risks associated with ownership of the assets.

d. **Venture capital Company:** An investor who either provides **capital** to startup **ventures** or supports small **companies** that wish to expand but do not have access to public funding.

e. **Asset financing companies:** '**Asset Financing**' Using balance sheet **assets** (such as accounts receivable, short-term investments or inventory) to obtain a loan or borrow money - the borrower provides a security interest in the **assets** to the lender.

   An AFC is a *company* which is a *financial* institution carrying on as its principal business the *financing* of physical *assets* supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments

f. **Factoring:** 'Factor' A financial intermediary that purchases receivables from a company. A factor is essentially a funding source that agrees to pay the company the value of the invoice less a discount for commission and fees.

RBI framework and act for NBFC

Regulations governing NBFCs in India

- The minimum net worth funds (NOF) of two crore is required to be maintain by companies who are willing to **registered NBFC** in India
- NBFCs ought to maintain ten percent of their deposit as liquid assets.
- NBFCs are not permitted to accept deposits which are repayable on demand.
- They are not allowed to cap (limit) the interest rate higher than ceiling rate mentioned by the Reserve bank of India.
- Offering gift or additional benefits to the depositors is not allowed.
- Reserve Bank of India shall not provide any assurance to the repayment of deposit made by the NBFC.
- They have to build a reservoir of the fund and transfer up to extend not less than 20% of their net deposit.
- RBI rules their functionalities regarding issues of disclosures, credit, prudential norms investments, etc.
- NBFCs depositors are eligible to avail of the nomination facility.
- NBFCs, particularly the unincorporated ones, are not eligible to accept deposits from the public.
- NBFC has to maintain a minimum capital adequacy norm of eight percent (8%).
- NBFCs are liable to avail minimum credit rating from credit rating agencies.
- NBFCs are bound to maintain a certain threshold of liquidity buffers related to the liquid asset to address the short-term liabilities. This will empower them to counteract the liquidity crisis with a minimum of hassle.
- The Reserve Bank of India as per ***RBI Act 1934***[1], reserve the right to register, issue directions, lay down policy, inspect, and conduct scrutiny over NBFCs.
- The Reserve Bank of India has the authority to penalize the NBFCs for infringing the compliances of RBI Act or the directions issues by RBI under the RBI Act.
- The penal action could lead the RBI to cancel the Certificate of Registration granted to the NBFC.
- It is illegal to pursue business without the approval from the Reserve Bank of India. Failing to this provision can endanger the existence of the concerned entities as RBI can enforce them to confront severe penalties.

- Every NBFC holding an asset value of Rs. 50 crore or more shall be entitled to constitute an audit committee in accordance with the last audited balance sheet. The committee must comprise of at least three members from the BOD.
- All the NBFCs are entitled to prepare their balance sheet along with P&L account on 31st March of every year.
- The board of directors of every NBFC that is willing to confer call loans must frame the policy for the same in the first place.
- NBFC must prepare Suspicious Transaction Report (STRs) in case if they have reason to believe that the specific transaction adheres to criminal activity regardless of the transaction amount.

FUND BASED FINANCIAL SERVICES

Some of the fund based financial services are leasing, hire purchase agreements. These are discussed below in detail in the pages to come.

LEASING: It is a contract by which one party conveys land, property, services etc., to another for a specified time.

Definitions: The Transfer of Property Act, 1882 (as amended in 1952) describes Lease as follows —
A Lease of the movable property is a transfer of a right to enjoy such property, made for a certain time, express of implied, or in perpetuity, inconsideration of a price paid or promised or of money, a share of crops, service or any other things of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms.
• The transferor is called the Lessor
• The transferee is called the Lessee

Contents of a Lease Agreement:
The lease agreement specifies the legal rights and obligations of the lessor and the lessee.
It typically contains terms relating to the following:
 Description of the lessor, the lessee, and the equipment.

 Amount, time and place of lease rentals payments.

 Time and place of equipment delivery.

 Lessee‟s responsibility for taking delivery and possession of the leased equipment.

 Lessee‟s responsibility for maintenance, repairs, registration, etc. and the lessor‟s right in case of default by the lessee.

 Lessee‟s right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.

 Insurance to be taken by the lessee on behalf of the lessor.

 Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.

 Options of lease renewal for the lessee.

 Return of equipment on expiry of the lease period.

 Arbitration procedure in the event of dispute.

Types of Leasing : Classification of Lease

A. Finance Lease: A lease is defined as a finance lease if it transfers a substantial part of the **risks** and **rewards** associated with ownership from the **lessor** to the **lessee**.

Thus the finance lease is characterized by whether:

a) The lease transfers ownership of the asset to the lessee by the end of the lease term; or

b) The lessee has the option to purchase the asset at a price within is expected to be sufficiently lower than the Fair Market Value (FMV) at the date, the option becomes exercisable that, at the inception of the lease it is reasonably certain that the option will be exercised; or

c) The lease term is for a major part of the useful life of the asset. The title may or may not be transferred eventually; or

d) The Present Value of the minimum lease payments is greater than or substantially equal to the Fair Market Value (FMV) of the asset at the inception of the lease. The title may or may not be transferred eventually.

B. Operating Lease.

The International Accounting Standard Committee defines operating lease as **"any lease other than a finance lease".** An operating lease has the following characteristics:

1. The lease term is significantly less than the economic life of the equipment.
2. The lessee enjoys the right to terminate the lease at short notice without any significant penalty.
3. The lessor usually provides the operating know-how, supplies the related services and undertakes the responsibility of insuring and maintaining the equipment, in which case the operating lease is called a **Wet Lease**.
4. An operating lease where the lessee bears the cost of insuring and maintaining the leased equipment is called a **Dry Lease**.
5. An operating lease does not shift the equipment-related, business and technological risks from the lessor to lessee. The lessor structuring an operating lease transaction has to depend upon

C. Sale and Lease Back

In the case of sale and lease back, the owner of equipment sells it to a leasing company, which, in turn, lease it back to the seller of the equipment, who then becomes the lessee.

The Lease Back arrangement in this transaction can be in the form of either a finance lease or an operating lease e.g., the sale and lease back of safe deposit vaults practiced by commercial banks. The banks sell the safe deposit vaults in its custody to a leasing company at a market

price, which is substantially higher than the book value. The leasing company then offers these lockers on a long-term lease to the bank. This sale and lease back= arrangement is an easily

D. Direct Lease

It is defined as any lease, which is not a sale and lease back transaction, A direct lease can be of two types: (i) Bipartite lease, and (ii) Tripartite Lease.

E. Bipartite Lease:

There are two parties to the transaction, 1. Equipment supplier cum lessor 2. The lessee. It functions like an operating lease with built-in facilities like up gradation of the equipments called as Upgrade Lease. The lessor undertakes to maintain the equipment and even replaces the equipment that is in need of major repair with the similar functioning equipment called as Swap Lease‖.

F. Tripartite Lease

It involves three different parties
1. The equipment supplier
2. The lessor
3. The lessee. Most of the equipment lease transactions fall under this category.

In this form of lease

1. The equipment supplier may provide a reference about the customer to the leasing company.

2. The equipment supplier can negotiate the terms of the lease with the customer and complete the necessary paper work on behalf of the leasing company.

3. The supplier can take the lease on his own account and discount the lease receivables with the designated leasing company. So the leasing company owns the equipment and obtains an assignment of the lease rentals. This form of lease has recourse to the supplier in case of default by the lessee, either to buy back the equipment from the lessor on default or providing a guarantee on behalf of lessee.

G. Single Investor Lease

The entire investment is funded by the lessor by arriving at a judicious mix of debt and equity. The debt funds raised by the leasing company are without recourse to the lessee, i.e., in the event of the default by the leasing company on its debt-servicing obligation, the lender cannot demand payment from the lessee.

H. Leveraged Lease

It is a lease which is leveraged through a trustee. The leasing company invests in equipments by borrowing large investments with full recourse to the lessee without any recourse to it.

A leveraged lease or leased lender is a lease in which the lessor puts up some of the money required to purchase the asset and borrows the rest from a lender.

The lender (loan participant) gets an assignment of the lease and enjoys benefit of the rentals to be paid by the lessee and a first mortgage on the leased assets.

This transaction is routed through the trustee to take care of the lender and the lessee.

I. **Domestic lease vs. International lease** – In domestic lease the lessor and lessee are from same country. On the other hand, if the lessor and lessee are domiciled in different countries, it is a international lease.

HIRE PURCHASES

- It is a method of selling goods.
- In Hire Purchase (H.P) transaction the goods are let out on hire by a finance company. **The buyer is required to pay an agreed amount in periodical installments during a given period.** The ownership of the property remains with creditor and passes on to hirer on the payment of last installment

FEATURES OF HIRE PURCHASE

- Buyer takes possession of goods immediately and agrees to pay total price in installments.
- Each installment is treated as hire charges
- The ownership of goods passes from the seller to the buyer on the payment of the installment
- If buyer makes default in the payment of any installment, the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charged.
- The hirer has right to terminate the agreement any time before the property passes

There are two parties in a hire purchase contract

1. The intending seller AND The intending purchaser or the hirer.
2. Tripartite agreement 1. Seller 2. Financier 3. Hirer/Purchaser

Difference between Hire Purchase and Leasing

Characteristics	Leasing	Hire purchasing
Ownership	With the finance company, the lessor	It is transferred to the hirer on the payment of the last installment
Depreciation	Lessor, and not the lessee is entitled to claim depreciation tax shield	The hirer is entitled to claim depreciation tax shield
Capitalization	Done in the books of lessor	Done in the books of hirer

Payments	The entire lease payments are eligible for tax computation in the books of lessee	Only the hire interest is eligible for tax computation in the books of Hirer
Magnitude	Used as a source of finance, usually for acquiring high cost assets such as machinery, ships etc	Used as a source of finance, usually for acquiring low cost assets such as automobiles, office equipments etc
Maintenance of asset	Lessee in case of financial, Upkeep is the responsibility of the lessor in the case of operating lease	It is the hirer‘s responsibility to ensure the maintenance of the asset Bought
Nature of asset	Asset- as a fixed asset of the lessor	Shows the asset either as a stock in trade or as receivables
Down payment	No down payment required	It is required

FINANCIAL EVALUATION

It is an evaluation by the hirer of the desirability for lease and hire purchase. The hirer makes decision based on the Present Value of Net Cash Outflow.

The decision is considered favorable when the PV of Net Cash Outflow under Hire Purchase is less than the PV of Net cash Out flow under leasing.

Following are the steps involved.

Step 1 Calculate annual interest amount

Step 2 Find the principal amount outstanding at the beginning of the each year = Total outstanding principal – principal paid in the previous year.

Step 3 Find principal paid in the previous year = Annual installment amount – Annual Interest

Step 4 Find Annual ITS = Annual Interest x Tax rate

Step 5 Find Annual Depreciation

Step 6 Find Annual DTS = Annual depreciation x Tax rate

Step 7 Find Total TS = Step 4 + Step 6

Step 8 Find Annual installment amount = Total HP amount + (HP amount x flat rate of interest) /No. of HP years

Step 9 Find PV of salvage value of assets = SV x PVF

Step 10 Find Net Cash Outflow of HP = Step 8 – Step 7

* Salvage value is **the book value of an asset after all depreciation has been fully expensed**.

UNDERWRITING

It is a process of placing a new issue with investors. Underwriting involves the issuing company using one or (usually) more companies (Banks) who are responsible for placing a certain amount of the new issue.

The underwriting firms (Banks) contact potential investors to gauge interest and sell the issue. Underwriters guarantee the marketability of a certain number of shares of the new issue.

Bracketing

This is a process of arranging groups of underwriters responsible for placing a new issue with investors into a hierarchy. This hierarchy indicates how much of an issue each group of underwriters is placing with respect to the others. The brackets are called, from largest to smallest: bulge bracket, major bracket, minor bracket, underwriter, selling group. The second largest bracket is sometimes called the mezzanine bracket. Brackets are listed in order of size on an advertisement detailing each new issue, known as the tombstone.

Oversubscription

If investors order more shares than there are shares being issued, the security is said to be oversubscribed. This may affect the price when the security is actually issued.

The underwriting process

1. Evaluating loss exposures
2. Identifying, developing and evaluating alternatives
3. Selecting an alternative – determining an appropriate premium
4. Implementing decisions
5. Monitoring exposures

Services provided by underwriters

- Formulate method used to issue securities
- Price the securities
- Sell the securities
- Price stabilization by lead underwriter

- Syndicate – group of investment bankers that market the securities and share the risk associated with selling the issue
- Spread – difference between what the syndicate pays the company and what the security sells for initially in the market
- Green shoe option

  Green-shoe option is a special provision in an IPO prospectus, which allows underwriters to sell investors more shares than originally planned by the issuer. This would normally be done if the demand for a security issue proves higher than expected. Legally referred to as an over-allotment **option**

MUTUAL FUND

A mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is "mutual" as all of its returns, minus its expenses, are shared by the fund's investors.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a 'a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments'.

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a Trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

- Portfolio management services
- Management of offshore funds
- Providing advice to offshore funds
- Management of pension or provident funds
- Management of venture capital funds
- Management of money market funds
- Management of real estate funds

A mutual fund serves as a link between the investor and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders.

Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilizing the savings of small investors and channelizing the same for productive ventures in the Indian economy.

Benefits of Mutual Funds

An investor can invest directly in individual securities or indirectly through a financial intermediary. Globally, mutual funds have established themselves as the means of investment for the retail investor.

1. **Professional management:** An average investor lacks the knowledge of capital market operations and does not have large resources to reap the benefits of investment. Hence, he requires the help of an expert. It, is not only expensive to 'hire the services' of an expert but it is more difficult to identify a real expert. Mutual funds are managed by professional managers

who have the requisite skills and experience to analyze the performance and prospects of companies. They make possible an organized investment strategy, which is hardly possible for an individual investor.

2. **Portfolio diversification**: An investor undertakes risk if he invests all his funds in a single scrip. Mutual funds invest in a number of companies across various industries and sectors. This diversification reduces the riskiness of the investments.

3. **Reduction in transaction costs**: Compared to direct investing in the capital market, investing through the funds is relatively less expensive as the benefit of economies of scale is passed on to the investors.

4. **Liquidity**: Often, investors cannot sell the securities held easily, while in case of mutual funds; they can easily en cash their investment by selling their units to the fund if it is an open-ended scheme or selling them on a stock exchange if it is a close-ended scheme.

5. **Convenience:** Investing in mutual fund reduces paper work, saves time and makes investment easy.

6. **Flexibility**: Mutual funds offer a family of schemes; and investors have the option of transferring their holdings from one scheme to the other.

7. **Tax benefits** Mutual fund investors now enjoy income-tax benefits. Dividends received from mutual funds' debt schemes are tax exempt to the overall limit of Rs 9,000 allowed under section 80L of the Income Tax Act.

8. **Transparency** Mutual funds transparently declare their portfolio every month. Thus an investor knows where his/her money is being deployed and in case they are not happy with the portfolio they can withdraw at a short notice.

9. **Stability to the stock market** Mutual funds have a large amount of funds which provide them economies of scale by which they can absorb any losses in the stock market and continue investing in the stock market. In addition, mutual funds increase liquidity in the money and capital market.
10. **Equity research** Mutual funds can afford information and data required for investments as they have large amount of funds and equity research teams available with them.

Types of Mutual Fund Schemes

The objectives of mutual funds are to provide continuous liquidity and higher yields with high degree of safety to investors. Based on these objectives, different types of mutual fund schemes have evolved.

A. Functional	*B. Portfolio*	*C. Geographical*	*D. Other*
Open-Ended Event	Income Funds	Domestic	Sectoral Specific
Close-Ended Scheme	Growth Funds	Off-shore	Tax Saving
Interval Scheme	Balanced Funds		ELSS
	Money Market		Special
	Mutual Funds		Gilt Funds
			Load Funds
			Index Funds
			ETFs
			PIE ratio fund

A. Functional Classification of Mutual Funds

1. **Open-ended schemes**: In case of open-ended schemes, the mutual fund continuously offers to sell and repurchase its units at net asset value (NAV) or NAV-related prices. Unlike close-ended schemes, open-ended ones do not have to be listed on the stock exchange and can also offer repurchase soon after allotment. Investors can enter and exit the scheme any time during the life of the fund. Open-ended schemes do not have a fixed corpus. The corpus of fund increases or decreases, depending on the purchase or redemption of units by investors.

   There is no fixed redemption period in open-ended schemes, which can be terminated whenever the need arises. The fund offers a redemption price at which the holder can sell units to the fund and exit. Besides, an investor can enter the fund again by buying units from the fund at its offer price. Such funds announce sale and repurchase prices from time-to-time. UTI's US-64 scheme is an example of such a fund.

   The key feature of open-ended funds is liquidity. They increase liquidity of the investors as the units can be continuously bought and sold. The investors can develop their income or saving plan due to free entry and exit frame of funds. Open-ended schemes usually come as a family of schemes which enable the investors to switch over from one scheme to another of same family.

2. **Close-ended schemes**: Close-ended schemes have a fixed corpus and a stipulated maturity period ranging between 2 to 5 years. Investors can invest in the scheme when it is launched. The scheme remains open for a period not exceeding 45 days. Investors in close-ended schemes can buy units only from the market, once initial subscriptions are over and thereafter the units are listed on the stock exchanges where they dm be bought and sold. The fund has no interaction with investors till redemption except for paying dividend/bonus. In order to provide an alternate exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. If an investor sells units directly to the fund, he cannot enter the fund again, as units bought back by the fund cannot be reissued. The close-ended scheme can be converted into an open-ended one. The units can be rolled over by the passing of a resolution by a majority of the

unit--holders.

3. **Interval scheme**: Interval scheme combines the features of open-ended and close-ended schemes. They are open for sale or redemption during predetermined intervals at NAV-related prices.

B. Portfolio Classification

Here, classification is on the basis of nature and types of securities and objective of investment.

1. **Income funds**: The aim of income funds is to providesafety of investments and regular income to investors. Such schemes invest predominantly in income-bearing instruments like bonds, debentures, government securities, and commercial paper. The return as well as the risk is lower in income funds as compared to growth funds.

2. **Growth funds**: The main objective of growth funds iscapital appreciation over the medium-to-long- term. They invest most of the corpus in equity shares with significant growth potential and they offer higher return to investors in the long-term. They assume the risks associated with equity investments. There is no guarantee or assurance of returns. These schemes are usually close-ended and listed on stock exchanges.

3. **Balanced funds**: The aim of balanced scheme is to provide both capital appreciation and regular income. They divide their investment between equity shares and fixed nice-bearing instruments in such a proportion that, the portfolio is balanced. The portfolio of such funds usually comprises of companies with good profit and dividend track records. Their exposure to risk is moderate and they offer a reasonable rate of return.
4. **Money market mutual funds**: They specialize in investing in short-term money market instruments like treasury bills, and certificate of deposits. The objective of such funds is high liquidity with low rate of return.

C. Geographical Classification

1. **Domestic funds**: Funds which mobilize resources from a particular geographical locality like a country or region are domestic funds. The market is limited and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.

2. **Offshore funds**: Offshore funds attract foreign capital for investment in ‘the country of the issuing company. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. Such mutual funds can invest in securities of foreign companies. They open domestic capital market to international investors. Many mutual funds in India have launched a number of offshore funds, either independently or jointly with foreign investment management companies. The first offshore fund, the India Fund, was launched by Unit Trust of India in July 1986 in collaboration with the US fund

manager, Merril Lynch.

D. Others

1. **Sectoral:** These funds invest in specific core sectors like energy, telecommunications, IT, construction, transportation, and financial services. Some of these newly opened-up sectors offer good investment potential.

2. **Tax saving schemes:** Tax-saving schemes are designed onthe basis of tax policy with special tax incentives to investors. These schemes contain various options like income, growth or capital application. The latest scheme offered is the Systematic Withdrawal Plan (SWP) which enables investors to reduce their tax incidence on dividends from as high as 30% to as low as 3 to 4%.

3. **Equity-linked savings scheme (ELSS):** In order to encourage investors to invest in equity market, the government has given tax-concessions through special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but these schemes carry a lock-in period before the end of which funds cannot be withdrawn.
4. **Special schemes:** Mutual funds have launched special schemes to cater to the special needs of investors. UTI has launched special schemes such as Children's Gift Growth Fund, 1986, Housing Unit Scheme, 1992, and Venture Capital Funds.

5. **Gilt funds:** Mutual funds which deal exclusively in gilts are called gilt funds. With a view to creating a wider investor base for government securities, the Reserve Bank of India encouraged setting up of gilt funds. These funds are provided liquidity support by the Reserve Bank.

6. **Load funds:** Mutual funds incur certain expenses such as brokerage, marketing expenses, and communication expenses. These expenses are known as 'load' and are recovered by the fund when it sells the units to investors or repurchases the units from withholders. In other words, load is a sales charge, or commission, assessed by certain mutual funds to cover their selling costs.

   Loads can be of two types-Front-end-load and back-end-load. Front-end-load, or sale load, is a charge collected at the time when an investor enters into the scheme. Back-end, or repurchase, load is a charge collected when the investor gets out of the scheme. Schemes that do not charge a load are called 'No load' schemes.

   In other words, if the asset management company (AMC) bears the load during the initial launch of the scheme, then these schemes are known as no-load schemes. However, these no-load schemes can have an exit load when the unit holder gets out of the scheme before a I stipulated period mentioned in the initial offer. This is done to prevent short-term investments and redemptions. Some funds may also charge different amount of loads to investors depending upon the time period the investor has stayed with the funds. The longer the

investor stays with the fund, less is the amount of exit load charged. This is known as contingent deferred sales' charge (CDSL). It is a back-end (exit load) fee imposed by certain funds on shares redeemed with a specific period following their purchase and is usually assessed on a sliding scale.

7. **Index funds:** An index fund is a mutual fund which investsin securities in the index on which it is based BSE Sensex or S&P CNX Nifty. It invests only in those shares which comprise the market index and in exactly the same proportion as the companies/weightage in the index so that the value of such index funds varies with the market index. An index fund follows a passive investment strategy as no effort is made by the fund manager to identify stocks for investment/dis-investment. In other words, the fund manager has to buy stocks which are added to the index and sell stocks which are deleted from the index.

8. **PIE ratio fund:** PIE ratio fund is another mutual fundvariant that is offered by Pioneer IT! Mutual Fund. The PIE (Price-Earnings) ratio is the ratio of the price of the stock of a company to its earnings per share (EPS). The PIE ratio of the index is the weighted average price-earnings ratio of all its constituent stocks.

   The PIE ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market. Broadly, around 90% of the investible funds will be invested in equity if the Nifty Index PIE ratio is 12 or below. If this ratio exceeds 28, the investment will be in debt/money markets. Between the two ends of 12 and 28 PIE ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

9. **Exchange traded funds:** Exchange Traded Funds (ETFs)are a hybrid of open-ended mutual funds and listed individual stocks. They are listed on stock exchanges and trade like individual stocks on the stock exchange. However, trading at the stock exchanges does not affect their portfolio. ETFs do not sell their shares directly to investors for cash. The shares are offered to investors over the stock exchange. ETFs are basically passively managed funds that track a particular index such as S&P CNX Nifty.

   Since they are listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by the demand-supply forces in the market. In practice, they trade in a small range around the value of the assets (NAV) held by them.

   Net Asset Value The net asset value of a fund is the marketvalue of the assets minus the liabilities on the day of valuation. In other words, it is the amount which the shareholders will collectively get if the fund is dissolved or liquidated. The net asset value of a unit is the net asset value of fund divided by the number of outstanding units.

   Thus NAV = Market Price of Securities + Other Assets - Total Liabilities + Units Outstanding as at the NAV date.

NAV = Net Assets of the Scheme + Number of units outstanding, that is, Market value of investments + Receivables + Other Accrued Income + Other Assets - Accrued Expenses - Other Payables - Other Liabilities + No. of units outstanding as at the NAV date.

A fund’s NAV is affected by four sets of factors: purchase and sale of investment securities, valuation of all investment securities held, other assets and liabilities, and units sold or redeemed.

BA 4003/ BANKING AND FINANCIAL SERVICES

UNIT - V
INSURANCE AND OTHER FEE BASED FINANCIAL SERVICES

INSURANCE

Insurance is a protection against a financial loss, arising on the happenings of an unexpected event.

It is contract between two parties whereby one party called insurer takes a fixed sum called premiums, in exchange to pay the other party on the happening of certain event.

Features of Insurance contract

1. **Insurable interest**

   The person entering into the contract (Policy holder) should have valid interest in the item being insured. This is called 'Insurable interest'. Any insurance contract without insurable interest is considered a void contract.

   But in case of some insurance schemes, the insurable interest is not necessary, such as accident insurance, vehicle insurance, etc.

2. **Utmost good faith**

   Insurance contracts are "Uberrimaefidae" (utmost good faith) contracts. Voluntary disclosure of all information pertinent to the contract is expected of both the insurer and insured.

3. **Indemnification**

   Every contract of insurance is a contract of indemnity, i.e, the indemnifier should provide assurance to save the counterparty from loss, caused by the action of indemnifier or a third party.

4. **Subrogation**

   It is the right for an insurer to pursue a third party that caused an insurance loss to the insured. This is done as a means of recovering the amount of the claim paid to the insured for the loss. If the insured suffers a loss due to the action of a third party and the insurance company has to take efforts to settle the insured's claim. (The insurance company can step into the shoes of the insured to recover the loss from the third party).

5. **Warranties**

   The insurer must comply with the conditions imposed by the insurance company. Otherwise the insurance company will not be liable to compensate loss to the ship if the express or implied warranties are violated.

6. **Proximate cause**

   The proximate cause is an event sufficiently related to a legally recognizable injury to be held to be the cause of that injury. *Insurance* Policies only provide cover for loss or damage if it is as a result of one of the perils listed. Example – If a machine is insured against floods and damage is caused due to collapse of the factory building in which the machine was kept, the insurance company is not liable to compensate even if the building collapse was due to floods.

7. **Assignment and nomination**

   Assignment is for loan granted to the insurer and nominee is the legal heir to the insurer.

Benefits of Insurance

1. Safeguard oneself and one's family for future requirements
2. Peace of mind in case of financial loss
3. Encourager savings
4. Get a tax rebate
5. Protection from claims made by creditors
6. Security against a personal loan, housing loan or other types of loan
7. Provide a protection cover to industries, agriculture, women and children.

Types of Insurance products & Services

a. Life insurance
b. Motor insurance
c. Property insurance
d. Fire insurance
e. Burglary - It covers all losses arising out of burglary committed in one's premises
f. Health insurance

Bancassurance

It refers to selling insurance products though banks' established distribution channels.

Based on Malhotra Committee recommendations, the government of India specified in August 2000 that 'Insurance' is a permissible form of business that could be undertaken by banks under section 6(1)(o) of the Banking Regulations Act, 1949. Subsequently, the RBI issued the guidelines on banks conducting insurance business.

Functions of Insurance Company

Primary Functions of Insurance

- Insurance provides certainty. Insurance provides certainty of payment at the uncertainty of loss.
- Insurance provides protection. The main function of insurance is to protect the probable chances of loss.
- Risk-Sharing.

7 functions of insurance

Primary

1. **Insurance provides certainty** - Insurance provides certainty of payment at the uncertainty of loss. The uncertainty of loss can be reduced by better planning and administration. But, the insurance relieves the person from such a difficult task.

2. **Insurance provides protection** : The main function of insurance is to protect the probable chances of loss. The time and amount of loss are uncertain and at the happening of risk, the person will suffer the loss in the absence of insurance. The insurance guarantees the payment of loss and thus protects the assured from sufferings.

3. **Risk-Sharing:** The risk is uncertain, and therefore, the loss arising from the risk is also uncertain. When risk takes place, the loss is shared by all the persons who are exposed to the risk.

Secondary

4. **Prevention of loss**: The insurance joins hands with those institutions which ate engaged in preventing the losses of the society because the reduction in loss causes the lesser payment to the assured arid so more saving is possible which will assist in reducing the premium. Lesser premium invites more business and more business causes lesser share to the assured.

5. **It Provides Capital:** The insurance provides capital to society. The accumulated funds are invested in the productive channel. The death of the capital of the society is minimized to a

greater extent with the help of investment in insurance. The industry, the business, and the individual are benefited by the investment and loans of the insurers.

6. It Improves Efficiency - Insurance eliminates worries and miseries of losses
7. It helps Economic Progress - The insurance by protecting the society from huge losses of damage, destruction, and death, provides an initiative to work hard for the betterment of the masses.

The Insurance act 1938

- Registration
- Licensing of agents
- Licensing of surveyors and loss assessors
- Solvency margin
- Payment of premium before assumption of risk

IRDA of India (IRDAI)

Insurance Regulatory and Development Authority -

The **Insurance Regulatory and Development Authority of India** (IRDAI) is a regulatory body under the jurisdiction of Ministry of Finance, Govt. of India.

- With the task of with regulating and regulating and Licensing the insurance and Re-insurance industries in India.

IRDA Act, 1999, an Act of Parliament passed by the Govt. of India. The agency's headquarters are in Hyderabad, Telangana, where it moved from New Delhi in 2001.

The IRDA itself when it became the authority to perform many tasks required to be done under the insurance act such as

- Issuing licenses,
- Issuing registration certificates,
- Monitoring compliance with the provisions of the Act,
- Issuing directives and
- Laying down norms.

Functions: The functions of the IRDAI are defined in Section 14 of the IRDAI Act, 1999 and include

- Issuing, renewing, modifying, withdrawing, suspending or cancelling registrations

- Protecting policyholder interests
- Specifying qualifications, the code of conduct and training for intermediaries and agents
- Specifying the code of conduct for surveyors and loss assessors
- Promoting efficiency in the conduct of insurance businesses
- Promoting and regulating professional organizations connected with the insurance and re-insurance industry
- Leaving fees and other charges
- Inspecting and investigating insurers, intermediaries and other relevant organisations
- Regulating rates, advantages, terms and conditions which may be offered by insurers not covered by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938)
- Specifying how books should be kept
- Regulating company investment of funds
- Regulating a margin of solvency
- Adjudicating disputes between insurers and intermediaries or
- insurance intermediaries
- Supervising the Tariff Advisory Committee
- Specifying the percentage of premium income to finance
- schemes for promoting and regulating professional organisations
- Specifying the percentage of life- and general insurance
- business undertaken in the rural or social sector
- Specifying the form and the manner in which books of accounts shall be maintained, and statement of accounts shall be rendered by insurers and other insurer intermediaries.

Insurance repository: The prime minister of India announced an insurance repository system, helping policyholders buy and maintain insurance policies in electronic form rather than on paper. Insurance repository, like share depositories or mutual

fund transfer agencies, will hold electronic records of insurance policies issued to individuals as electronic policies or e-policies.

SECTION 14 of IRDAI Act, 1999 lays down the Duties, Powers and Functions of IRDAI.

Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include,

- Issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;
- Protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;
- Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents
- Specifying the code of conduct for surveyors and loss assessors;
- Promoting efficiency in the conduct of insurance business;
- Promoting and regulating professional organisations connected with the insurance and re-insurance business;
- Levying fees and other charges for carrying out the purposes of this Act;
- Calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;
- Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);
- Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;
- Regulating investment of funds by insurance companies;
- Regulating maintenance of margin of solvency;
- Adjudication of disputes between insurers and intermediaries or insurance intermediaries;
- Supervising the functioning of the Tariff Advisory Committee;
- Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

- Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and
- Exercising such other powers as may be prescribed

VENTURE CAPITAL

Venture Capital Financing

Venture capital financing is a type of private equity investing specific to earlier-stage businesses that require capital. In return, the investor receives an equity stake in the business through the issuance of some type of security instrument.

Venture capital financing *is a high-risk, high return investment methodology in which the money is invested in the form of equity in a company that is privately held, i.e., not publicly traded on a stock exchange, and is planned for three broad stages of the company – idea, expansion, and exit stage.*

Venture Capital - made in following methods

1. **Equity Financing**
2. **Conditional Loan** -to pay the lender in the form of royalty when the company is able to generate revenue or profit.
3. **Conventional Loans -** a low-interest rate on the borrowed capital. The interest rate will increase as per the increase in profit
4. **Income Note** - combination of both the traditional loans and conditional loans (Interest & Royalty)
5. **Participating Debenture**
6. **"SAFE" Notes*:*** A SAFE (Simple Agreement for Future Equity) is a kind of convertible security that allows note holders to purchase a specified number of shares for an agreed-upon price at some point in the future.

FEATURES OF VENTURE CAPITAL

1. Financing of capital for new companies.

2. It is a loan-based or in convertible debentures

3. Providers of venture capital aim at capital gain due to the success achieved by the borrowing concern.

4. Venture capital is always a long-term investment and made in companies which have high growth potential.

5. The venture capital provider take part in the business of borrowing concern simultaneously provides managerial skill.

6. Venture capital financing contains risks. But the risk is compensated with a higher return.

7. Financing mainly small and medium size firms, in their early stages.

Stages of venture capital financing

Venture capital financing is quite helpful to nurture and grow a start-up into a profitable venture. Here are the different stages of venture capital financing.

1. Seed Stage

As the term suggests the start-up will grow by making use of the capital invested by angel investors or venture capitalists. In this stage, an investor investigates the business plan and the potential of the product or service to succeed in the future, which is to be delivered by the entrepreneur.

{Angel investors are individuals who invest in startups and young businesses by providing funding in exchange for equity (ownership shares) in the business }

2. Start-up Stage

If the idea/product has the potential to cater or solve any problem then the entrepreneur needs to submit the business plan along with,

- In-depth analysis of revenue model i.e. how the company generates revenue,
- Current competition in the peer industry or sector,
- Details of the management i.e. CEO, Director of the company and their work experience apart from educational qualification,
- Size and potential of the desired market.

After analysis of the above-mentioned points venture, capitalists decide whether they are going to invest.

At this stage, the risk factor is quite high because:

- There is an inherent risk of losing the invested capital if the business does not succeed.
- The money invested by the venture capitalists will be used for the development of product or services and marketing strategies.

3. Early-stage/First stage

This stage is also known as the emerging stage.

The capital received from the venture capitalists goes into manufacturing products or delivering services by setting up an office to capture the market shares from the competitors in the industry.

Venture capitalists watching : The management to know the : capacity of the management and how they can tackle the competition

In this stage, the capital is invested to grow inventory to increase sales.

4. The Expansion stage/Second stage/Third stage

In this stage, the capital is provided for marketing and promotion of the product, expansion, and acquisition to keep up with the demand of the product.

Venture capitalists funding for market expansion by setting up a new factory or acquisition of factory and product diversification.

5. The Bridge Stage/ IPO stage

This is the last stage of the venture capital financing process.

At this stage, the company gains a certain amount of market share. In this stage, the companies give the venture capitalists an opportunity to book the profit for the risk they have taken, and exit from the company by selling their share/stake when the company announces IPO.

The fund raised from IPO can be used for,

- Mergers and acquisitions.
- Reduction of price and other strategies to drive out peer competitors.
- Introduction of products or services to attract new customers and markets.

VENTURE CAPITAL - EXAMPLE

There are various venture capitalist firms which invest in technology-based and consumer services businesses from early to mid-stage venture.

- Kohlberg Kravis & Roberts [KKR] has funded Mumbai based polyester maker JBF Industries Ltd.

- Goldman Sachs and Zodius Technology have funded Pepperfry.com, the largest e-marketplace of furniture of India.

TDICI - Technology Development and Information company of India Ltd. This was started in January 1988 with the support of ICICI and UTI.

This is the country's first venture fund (Venture Capital Unit Scheme).

BILL OF EXCHANGE

A Bill of Exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Essential elements of a Bill of Exchange

1. Must be in writing
2. Three parties – drawer, drawee and payee
3. Order to pay – order by the drawer to the drawee
4. Must be unconditional
5. It must be signed by the drawer
6. The drawer, drawee & payee must be certain
7. Sum payable must be certain
8. The bill must certain an order to pay money only
9. Date & consideration must exist

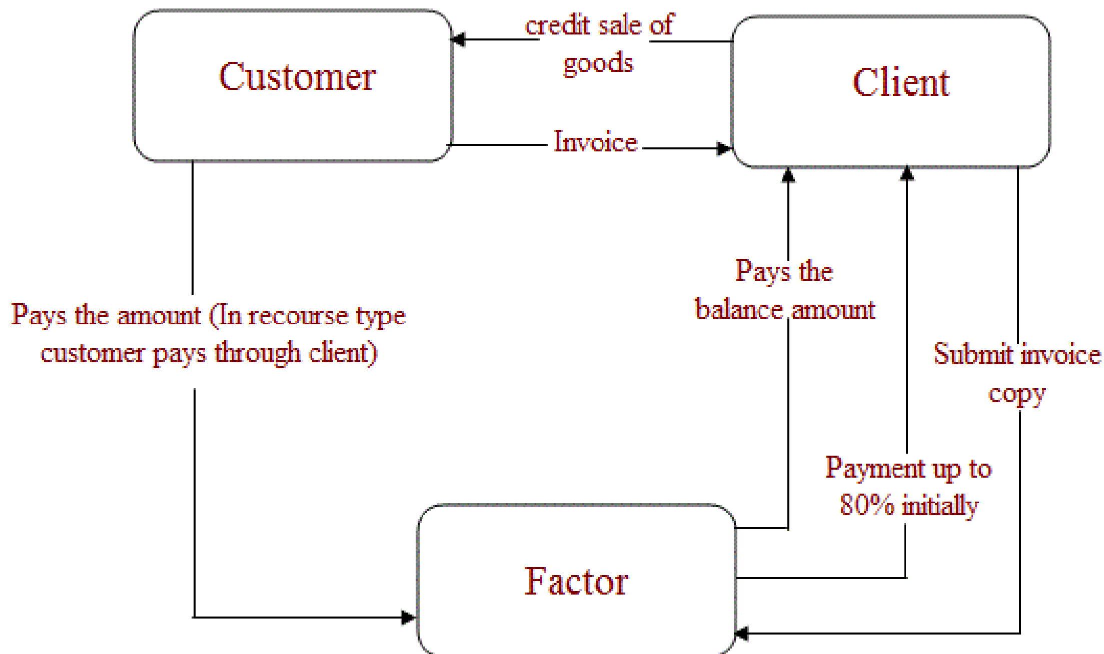
Rs.10000 **24.06.2022**
Three months after date I **promise** to pay to **Mr.C** or order the sum of Rs.10000 for value received
To A Accepted by A Stamp/ Signature

FACTORING

Factoring is **a type of finance in which a business would sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs**.

Under the transaction between both parties, the factor would pay the amount due on the invoices minus its commission or fees.

Factoring Services



Types of Factoring

1. Domestic Factoring: Factoring that arises from transactions relating to domestic sales.

2. Disclosed factoring: In the case of disclosed factoring‘ the name of the proposed Factor is mentioned on the face of the invoice made out by the seller of goods.

3. Undisclosed factoring: Under undisclosed factoring, the name of the proposed Factor finds no mention on the invoice made out by the seller of goods.

4. Discount factoring: Discount Factoring's a process where the Factor discounts the invoices of the seller at a pre-agreed credit limit with the institutions providing finance. Book debts and receivables serve as securities for obtaining financial accommodation.

5. Export Factoring: When the claims of an exporter are assigned to a banker or any financial institution, and financial assistance is obtained on the strength of export documents and guaranteed payments, it is called export factoring.

6. Cross-border Factoring: Cross-border Factoring involves the claims of an exporter which are assigned to a banker or any financial institution in the importer's country and financial assistance is obtained on the strength of the export documents and guaranteed payments. International factoring essentially works on a non-recourse factoring model.

7. With Recourse Factoring: The salient features of the type of factoring arrangement are as follows 1. The Factor has recourse to the client firm in the event of the book debts purchased becoming irrecoverable.

8. Without Recourse Factoring: The salient features of this type of factoring are as follows :

1. No right with the Factor to have recourse to the client

2. The Factor bears the loss arising out of irrecoverable receivables 3. The Factor charges higher commission called del credere commission.

MERCHANT BANKING

Merchant Banker **facilitates the issuers of securities (companies) to raise capital from the financial market by selling the securities.**

Securities and Exchange Board of India (Merchant Bankers) Rules, 1992.

A MERCHANT BANKER - any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management.

As of now there are **135 Merchant bankers** who are registered with SEBI in India. It includes Public Sector, Private Sector and foreign players some of them are.

a. PUBLIC SECTOR MERCHANT BANKERS

SBI capital markets ltd, Punjab national bank, Bank of Maharashtra, IFCI financial services ltd., Karur Vysya bank ltd, State Bank of Bikaner and Jaipur.

b. PRIVATE SECTOR MERCHANT BANKERS

ICICI Securities Ltd, Axis Bank Ltd (Formerly UTI Bank Ltd.), Bajaj Capital Ltd, Tata Capital Markets Ltd., ICICI Bank Ltd., Reliance Securities Limited., Kotak Mahindra Capital Company Ltd., Yes Bank Ltd.

c. FOREIGN PLAYERS IN MERCHANT BANKING

Barclays Bank Plc, Deutsche Bank, Goldman Sachs (India) Securities Pvt. Ltd., Morgan Stanley India Company Pvt. Ltd., Barclays Securities (India) Pvt. Ltd., Bank Of America. Deutsche Equities India Private Limited , Citigroup Global Markets India Pvt. Ltd.

SERVICES – Providing by Merchant Banker

PROJECT COUNSELING	RESTRUCTURING STRATEGIES
MANAGEMENT OF DEBT AND EQUITY OFFERINGS	OFF SHORE FINANCE
ISSUE MANAGEMENT	NON-RESIDENT INVESTMENT
MANAGERS, CONSULTANTS OR ADVISERS TO THE ISSUE	LOAN SYNDICATION
UNDERWRITING OF PUBLIC ISSUE	CORPORATE COUNSELING AND ADVISORY SERVICES
PORTFOLIO MANAGEMENT	PLACEMENT AND DISTRIBUTION

a. ***Corporate Finance Services. -***Corporate counseling covers counseling in the form of project counseling, capital restructuring, project management, public issue management, loan syndication, working capital fixed deposit, lease financing, acceptance credit etc.,

b. ***Project Finance Services.*** finance. It broadly covers the study of the project, offering advisory assistance on the viability and procedural steps for its implementation.

a. Identification of potential investment avenues.

b. A general view of the project ideas or project profiles.

c. Advising on procedural aspects of project implementation

d. Reviewing the technical feasibility of the project

e. Assisting in the selection of TCO=s (Technical Consultancy Organizations) for preparing project reports

f. Assisting in the preparation of project report

g. Assisting in obtaining approvals, licenses, grants, foreign collaboration etc., from government

h. Capital structuring

i. Arranging and negotiating foreign collaborations, amalgamations, mergers and takeovers.

c. International Finance Services.

Foreign Collaboration: Foreign collaboration arrangements are made by the Merchant bankers.

- Manages issue of Global Deposit Receipts (GDRs), American Depository Receipts (ADRs) and foreign currency convertible bond (FCCBs)
- Arrange External Commercial Borrowings (ECBs).

d. Miscellaneous services

- Stock broking, for both institutional and retail investors.
- Distribution of financial products.
- Dealing in currency derivatives.
- Asset management.
- Underwriting.
- Portfolio management services.
- Forex advisory services.
- Commodities broking.

SEBI Regulation

- The applicant must be a Corporate Body.
- The applicatant should not carry on a business other than the Securities Market Business
- He should have necessary infrastructure .
- The associate company or group of company should not have been registered merchant banker.
- The applicant should not been involve in security scams .
- The minimum net worth of the applicant firm should be Rs 50 million.

Capital adequacy of Merchant banker: **Four categories existed earlier :**

Category I – Capital Adequacy of Rs 5 Crores.
Category II – Capital Adequacy of Rs 50 Lakhs.
Category III – Capital Adequacy of Rs 20 Lakhs.
Category IV – No Capital Adequacy Requirementital Adequacy for Merchant Banker

Categories & Functions of Merchant Banker

Category I – Issue manager, underwriter, advisor, consultant and portfolio manager.
Category II – Issue manager, underwriter, advisor, consultant and portfolio manager.
Category III – Underwriter, advisor & consultant
Category IV – Advisor,& consultant.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

SEBI stands for Securities and Exchange Board of India.

- It is a statutory regulatory body that was established by the Government of India. in 1992.
- For protecting the interests of investors investing in securities along with regulating the securities market.
- SEBI also regulates how the stock market and mutual funds function.

SEBI has its headquarters at the business district of Bandra Kurla Complex in Mumbai and

- Has Northern, Eastern, Southern and Western Regional Offices in New Delhi, Kolkata, Chennai and Ahmedabad respectively.
- It has opened local office at Jaipur and Bangalore and has also
- Open Offices at Guwahati, Bhubaneshwar, Patna, Kochi and Chandigarh in Financial Year 2013–2014

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as

"...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected there with or incidental there to".

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SEBI has to be **responsive to the needs of three groups**, which constitute the market:

- Issuers of securities
- Investors
- Market intermediaries

Functions of SEBI

- SEBI has the following functions
  1. Protective Function
  2. Regulatory Function
  3. Development Function

1. **Protective Function**: The protective function implies the role that SEBI plays in protecting the investor interest and also that of other financial participants.
   a. **Prohibits insider trading:** Insider trading is the act of buying or selling of the securities by the insiders of a company, which includes the directors, employees and promoters.

   b. **Check price rigging:** Price rigging is the act of causing unnatural fluctuations in the price of securities by either increasing or decreasing the market price of the stocks that leads to unexpected losses for the investors.

   c. **Promoting fair practices:** SEBI promotes fair trade practice and works towards prohibiting fraudulent activities related to trading of securities.

   d. **Financial education provider**: SEBI educates the investors by conducting online and offline sessions that provide information related to market insights and also on money management.

2. **Regulatory Function:** Regulatory functions involve establishment of rules and regulations for the financial intermediaries along with Corporates The following are some of the regulatory functions.

a. SEBI has defined the rules and regulations and formed guidelines and code of conduct that should be followed by the corporates as well as the financial intermediaries.
b. Regulating the process of taking over of a company.
c. Conducting inquiries and audit of stock exchanges.
d. Regulates the working of stock brokers, merchant brokers.

3. **Developmental Function:** Developmental function refers to the steps taken by SEBI in order to provide the investors with a knowledge of the trading and market function.
   a. Training of intermediaries who are a part of the security market.
   b. Introduction of trading through electronic means or through the internet by the help of registered stock brokers.
   c. By making the underwriting an optional system in order to reduce cost of issue.