UNIT 1

History of Indian Banking System: An Overview

The Banking system of the country is the base of the economy and economic development of the country. It is the most leading part of the financial sector of the country as it is responsible for more than 70 % of the funds flowing through the financial sector in the country.

The banking system in the country has three primary functions:

- Operations of Payment system
- Depositor and protector of people's savings
- Issue loans to individual and Companies

The Banking system in India can be categorised in two phases

- Pre-Independence Phase (1786-1947)
- Post- Independence Phase (1947 to till date)

The post-Independence period may further be divided into three phases-

- Pre-nationalisation Period (1947 to 1969)
- Post nationalisation Period (1969 to 1991)
- Liberalisation Period (1991 to till date)

Pre-Independence Phase (1786-1947)

The origin of the Banking system in India can be traced with the foundation of Bank of Calcutta in 1786. The Banking in India originates in the last decade in the 18^{th} century with the foundation of the English Agency houses in Bombay and Calcutta (now Kolkata).

- Three presidency banks Bank of Bengal, Bank of Bombay and Bank of Madras established in the 19^{th} Century under the charter of the British East India Company.
- In 1935, the presidency banks merge together and formed a new bank named Imperial Bank of India.
- The Imperial Bank of India subsequently named the State Bank of India.
- The first Indian-owned Allahabad Bank was set up in 1865 in Allahabad.
- In 1895, the Punjab National Bank was established in 1895.
- The Bank of India founded in 1906 in Mumbai.
- Many more commercial banks such as Canara Bank, Indian Bank, Central Bank of India, Bank of Baroda and Bank of Mysore were established between 1906 and 1913 under Indian ownership.
- The central Bank of India, RBI establish in 1935 on the recommendation of Hilton-Young Commission.

Post- Independence Phase (1947 to till)

- At the time independence, the entire Banking sector was under private ownership. The rural population of the country had to dependent on small money lenders for their requirements. To solve these issues and better development of the economy the Government t of India nationalised the Reserve Bank of India in 1949.
- In 1952, A commitee lead by A. D. GORWALA recommend the nationalization of banks and renaming the Imperial Bank of India as State Bank of India. ➡ The Imperial Bank of India was renamed as SBI by passing State Bank of India act 1955.
- The Banking Regulation Act enacted in 1949.

Nationalisation Period (1969 to 1991) In 1969, Government of India nationalised 14 major banks whose national deposits were more than 50 crores.

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

The Indian Banking system immensely developed after nationalisation but the rural and weaker section of the society was still not covered under the system.

To solve these issues, the ***Narasimham Committee*** in 1974 recommended the establishment of ***Regional Rural Banks (RRB).*** On 2nd October 1975, RRBs were established with an objective to extend the amount of credit to the rural section of the society.

- Six more banks further nationalised in the year 1980. With the second wave of nationalisation, the target of priority sector lending was also raised to 40%.

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Commerce
5. Punjab & Sindh Bank

6. Vijaya Bank

Liberalisation Phase (1990 to till)

In order to improve financial stability and profitability of Public Sector Banks, the Government of India set up a committee under the chairmanship of Shri. M. Narasimham. The committee recommended several measures to reform banking system in the country.

- The major thrust of the recommendations was to make banks competitive and strong and conducive to the stability of the financial system.
- The committee suggested for no more nationalisation of banks.
- Foreign banks would be allowed to open offices in India either as branches or as subsidiaries.
- In order to make banks more competitive, the committee suggested that public sector banks and private sector banks should be treated equally by the Government and RBI.
- It was emphasised that banks should be encouraged to abandon the conservative and traditional system of banking and adopt progressive function such as merchant banking and underwriting, retail banking, etc.
- Now, foreign banks and Indian banks permitted to set up joint ventures in these and other newer forms of financial services.
- 10 Privates players got a license from the RBI to entry in the Banking sector. These were Global Trust Bank, ICICI Bank, HDFC Bank, Axis Bank, Bank of Punjab, IndusInd Bank, Centurion Bank, IDBI Bank, Times Bank and Development Credit Bank.

The Government of India accepted all the major recommendation of the committee.

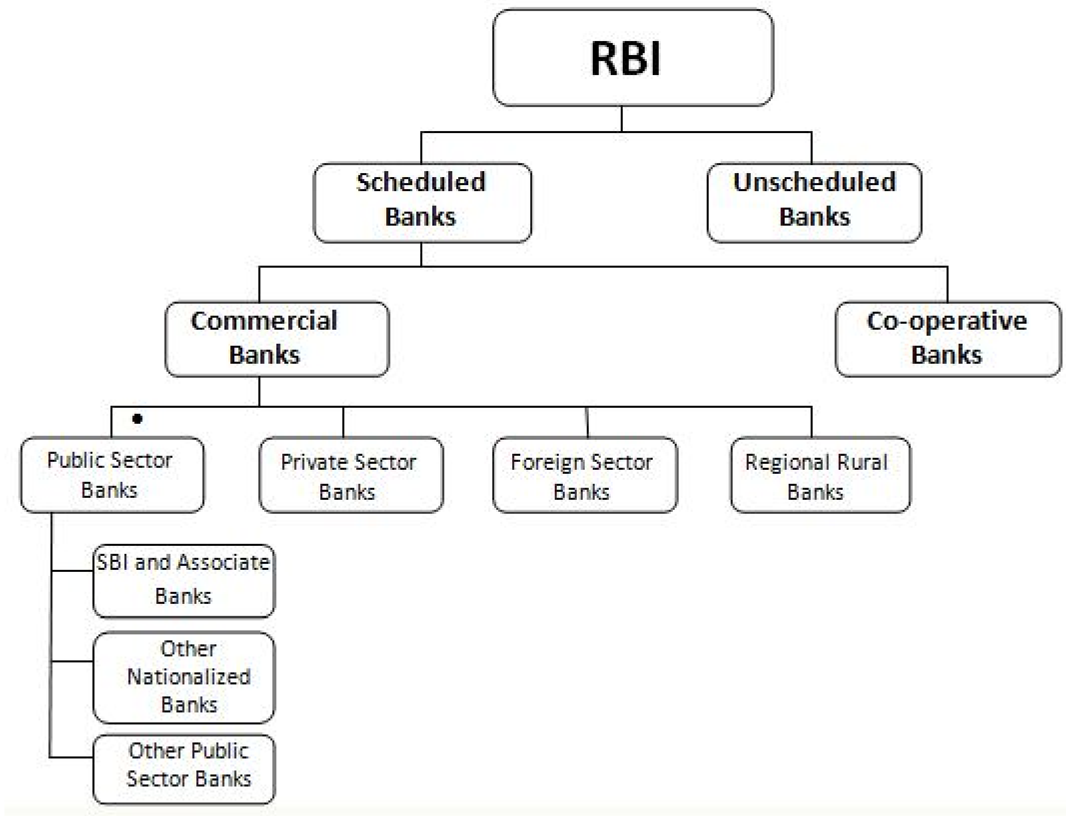
Recent Development in Indian Banking Sector:

- Kotak Mahindra Bank and Yes Bank got a license from RBI to entry in the system in the year 2003 and 2004.
- In 2014, RBI grants in-principle approval to IDFC and Bandhan Financial Services to set up banks.

Today, Indian Banking industry is one of the most growing flourishing industries. Banking systems of any country need to be effective, efficient as it plays the active in the economic development of the country.

STRUCTURE OF THE INDIAN BANKING

The Indian financial system comprises a large number of commercial and cooperative banks, specialized developmental banks for industry, agriculture, external trade and housing, social security institutions, collective investment institutions, etc. The banking system is at the heart of the financial system.The Indian banking system has the RBI at the apex. It is the central bank of the country under which there are the commercial banks including public sector and private sector banks, foreign banks and local area banks. It also includes regional rural banks as well as cooperative banks.



<u>Reserve Bank of India</u>

The central bank plays an important role in the monetary and banking structure of nation. It supervises controls and regulates the activities of the banking sector. It has been assigned to handle and control the currency and credit of a country. The first central bank in the world was Riks Banks of Sweden which was established in 1656. The Reserve Bank of India, the central bank of our country, was established in 1935 under the aegis of Reserve Bank of India Act, 1934. It is the oldest central bank among the developing countries. As the apex bank, it has been guiding, monitoring, regulating and promoting the destiny of the Indian financial system. The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated.Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

Preamble

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

Objectives of RBI

It plays a more positive and dynamic role in the development of a country. The financial muscle of a nation depends upon the soundness of the policies of the central banking. The objectives of the central banking system are presented below:

- ***The central bank should work for the national interest of the country.***
- ***The central bank must aim for the stabilization of the mixed economy.***
- ***It aims at the stabilization of the price level at average prices.***
- ***Stabilization of the exchange rate is also essential.***
- ***It should aim for the promotion of economic activities.***

Constitution and Management

Reserve Bank of India has been constituted as a corporate body having perpetual succession and a common seal. *Its capital is Rs. 5 crore wholly owned by the Government of India*. The general superintendence and direction of the affairs and business of the Bank has been vested in the Central Board of Directors. The Central Government, however, is empowered to give such directions to the Bank as it may, after consultation with its Governor, consider necessary in the public interest.
The Central Board of Directors consists of the following:

- ***A Governor and not more than four Deputy Governor to be appointed by the Central Government.***
- ***Four directors to be nominated by the Central Government, one from each of the four local boards.***
- ***Ten directors to be nominated by the Central Government.***
- ***Two Government official to be nominated by the Central Government.***

Besides the Central Board of Directors, four Local Boards have also been constituted for each of the four areas specified in the first schedule to the Act. A Local Board has five members appointed by the Central Government to represent as far as possible, territorial and economic interests and the interests of cooperative and indigenous banks. A Local Board advises the Central Board on matters referred to it by the Central Board and performs such duties as are delegated to it by the Central Board.

Functions of RBI

The RBI functions are based on the mixed economy. The RBI should maintain a close and continuous relationship with the Union Government while implementing the policies. If any differences arise, the government's decision will be final. The main functions of the RBI are presented below:

- ***Welfare of the public***
- ***To maintain the financial stability of the country.***
- ***To execute the financial transactions safely and effectively.***
- ***To develop the financial infrastructure of the country.***
- ***To allocate the funds effectively without any partiality.***
- ***To regulate the overall credit volume for price stability.***

Authorities

The RBI has the full authority in the following aspects:

- ***Currency issuing authority***
- ***Monitoring authority***
- ***Banker to the Union Government***
- ***Foreign exchange control authority***
- ***Promoting authority.***

1. Currency Issuing Authority- the RBI has the sole authority to issue the currency notes and coins. It is the fundamental right of the RBI. The coins and one rupee notes are issued by the Government of India and they are circulated through the RBI. The notes issued by the RBI will have legal identity everywhere in India. The RBI issues currency notes, based on the availability of balances of gold, bullion, foreign securities, rupees, coins and permitted bills.

2. Monitoring Authority- the RBI has the full authority to control all the aspects of the banking system in India. The RBI is known as the Banker's Bank. The banking system in India works according to the guidelines issued by the RBI. The RBI is the premier banking institute among the commercial banks. The RBI has the authority to control the credit supply in the economy or monetary systems of the nation.

3. Banker to the Union Government- Generally in any country all over the world the Central bank dominates the banking sector. It advises the government on monetary policies. The RBI is the bankers to the Union Government and also to the state governments in the country. It provides a wide range of banking services to the government. It also transfers the funds, collects the receipts and makes the payment on behalf of the Government. It also manages the public debts. The Government will not pay any remuneration or brokerage to the RBI for rendering the financial services. Any deficit or surplus in the Central Government account with the RBI will be adjusted by creation or cancellation of the treasury bills. The treasury bills are known as the Adhoc Treasury bills.

4. Foreign Exchange Regulation Authority- The RBI’s another major function is to control the foreign exchange reserves position from time to time. It maintains the stability of the external value of the rupee through its domestic policies and forex market. The RBI has the full authority to regulate the market as discussed below:

- *To monitor the foreign exchange control.*
- *To prescribe the exchange rate system.*
- *To maintain a better relation between rupee and other currencies.*
- *To interact with the foreign counterparts.*
- *To manage the foreign exchange reserves.*

It administers the FERA, 1973. It is replaced by the FEMA which would be consistent with full capital account convertibility with policies of the Central Government.
The RBI administers the control through the authorized forex dealers. The RBI is the custodian of the country’s foreign exchange reserves. The foreign exchange is precious and it takes the responsibility of the better utilization.

5. Promoting Authority-The RBI’s function is to look after the welfare of the financial system. It renders the promotion services to strengthen the country’s banking and financial structure. It helps in mobilizing the savings and diverting them towards the productive channel. Thus the economic development can be achieved. After the nationalization of the commercial banks, the RBI has taken a number of series of actions in various sectors such as agriculture sector, industrial sector, lead bank scheme and cooperative sector.

Scheduled & Non –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. Non-scheduled banks are those which are not included in the second schedule of the RBI Act, 1934. At present these are only four such banks in the country. Four Non-scheduled banks under operation in India are:

1. Akhand Anand Co-operative Bank Limited
2. Alavi Co-Operative Bank Limited
3. Amarnath Co-Operative Bank Limited

4. Amod Nagrik Sahakari Bank Limited

Commercial Banks

Commercial banks may be defined as, any banking organization that deals with the deposits and loans of business organizations. Commercial banks issue bank checks and drafts, as well as accept money on term deposits. Commercial banks also act as moneylenders, by way of installment loans and overdrafts. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals.Types of Scheduled Commercial Banks-

Public Sector Banks-These are banks where majority stake is held by the Government of India. Examples of public sector banks are: SBI, Bank of India, Canara Bank, etc.

Private Sector Banks-These are banks majority of share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. Examples of private sector banks are: ICICI Bank, Axis bank, HDFC, etc.

Foreign Banks-These banks are registered and have their headquarters in a foreign country but operate their branches in our country. Examples of foreign banks in India are: HSBC, Citibank, Standard Chartered Bank, etc

Regional Rural Banks-Regional Rural Banks were established under the provisions of an Ordinance promulgated on the 26th September 1975 and the RRB Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area as notified by GoI covering one or more districts in the State.

RRBs are jointly owned by GoI, the concerned State Government and Sponsor Banks (27 scheduled commercial banks and one State Cooperative Bank); the issued capital of a RRB is shared by the owners in the proportion of 50%, 15% and 35% respectively. **Prathama bank is the first Regional Rural Bank in India located in the city Moradabad in Uttar Pradesh.**

Type of Commercial Banks	Major Shareholders	Major Players
Public Sector Banks	Government of India	SBI, PNB, Canara Bank, Bank of Baroda, Bank of India, etc
Private Sector Banks	Private Individuals	ICICI Bank, HDFC Bank, Axis Bank, Kotak Mahindra Bank, Yes Bank etc.
Foreign Banks	Foreign Entity	Standard Chartered Bank, Citi Bank, HSBC, Deutsche Bank, BNP Paribas, etc.
Regional Rural Banks	Central Govt, Concerned State Govt and	Andhra Pradesh Grameena Vikas Bank, Uttranchal Gramin Bank,

	Sponsor Bank in the ratio of 50 : 15 : 35	Prathama Bank, etc.

Cooperative Banks

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, etc).

They provide limited banking products and are specialists in agriculture-related products.

Cooperative banks are the primary financiers of agricultural activities, some small-scale industries and self-employed workers. Co-operative banks function on the basis of “no-profit no-loss”.

Anyonya Co-operative Bank Limited (ACBL) is the first co-operative bank in India located in the city of Vadodara in Gujarat.

The co-operative banking structure in India is divided into following main 5 categories:

•	Primary Urban Co-op Banks
•	Primary Agricultural Credit Societies
•	District Central Co-op Banks
•	State Co-operative Banks
•	Land Development Banks

Difference between Scheduled Commercial and Schedule Co-operative 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.Also,unlike commercial banks ,these banks work on the basis of “no-profit no-loss”.

Types of Businesses of Banks

The banking business can be broadly categorized into Retail Banking, Wholesale or Corporate Banking, Treasury Operations and Other Banking Activities.

Business Segmentation	
Retail Banking	Loans to individuals (Housing loan, Auto loan, Education loan and other personal loan) or small businesses.
Wholesale banking	Loans to mid and large corporate (Project Finance, Working Capital Loans, Terms Loans, Lease Finance, etc.)
Treasury Operations	Investment in bonds, equity, Mutual Funds, commodities, derivatives; trading and forex operations
Other Banking Activities	Hire purchase activities, leasing business, merchant banking, Syndication services, etc.

1-Retail banking also known as Consumer Banking is the provision of services by a bank to individual consumers, rather than to companies, corporations or other banks. Services offered include savings and transactional accounts, mortgages, personal loans, debit cards, and credit cards. Retail banking segment is the highest margin business as compared to other business segments in the banking industry. Currently, ICICI Bank is the largest players in this segment in India. Other major players in this segment are SBI, PNB, HDFC Bank, etc.

Typical products offered by a retail bank include: Savings /Current accounts, Debit cards, ATM cards, Credit cards, Traveler's Cheque, Mortgages, Home equity loans, Personal loans, Certificates of deposit/Term deposits, etc.

2-Wholesale banking is the provision of services by banks to organizations such as Mortgage Brokers, large corporate clients, mid-sized companies, real estate developers and investors, international trade finance businesses, institutional customer(such as pension funds and government entities/agencies), and services offered to other banks or other financial institutions. Wholesale finance refers to financial services conducted between financial services companies and institutions such as banks, insurers, fund managers, and stockbrokers.

Modern wholesale banks engage in: Finance wholesaling, Underwriting, Market making, Consultancy, Mergers and acquisitions, Fund management

Wholesale banking segment in India is largely dominated by large Indian banks – SBI, ICICI Banks, PNB, BoB, etc.

3-Treasury management (or treasury operations) includes management of an enterprise's holdings, with the ultimate goal of managing the firm's liquidity and mitigating its operational, financial and reputational risk. Treasury Management includes a firm's collections, disbursements, concentration, investment and funding activities. In larger firms, it may also include trading in bonds, currencies, financial derivatives and the associated financial risk management. Most banks have whole departments devoted to treasury management and supporting their clients' needs in this area

Bank Treasuries may have the following departments:

•	A Fixed Income or Money Market desk that is devoted to buying and selling interest bearing securities
•	A Foreign exchange or “FX” desk that buys and sells currencies
•	A Capital Markets or Equities desk that deals in shares listed on the stock market.

Monetary Policy: An overview

Monetary policy refers to the credit control measures adopted by the central bank of a country. In case of Indian economy, RBI is the sole monetary authority which decides the supply of money in the economy. The Chakravarty committee has emphasized that price stability, growth, equity, social justice, promoting and nurturing the new monetary and financial institutions have been important objectives of the monetary policy in India.

Instruments of Monetary Policy

The instruments of monetary policy are of two types:

1. Quantitative, general or indirect (CRR, SLR, Open market operations, bank rate, repo rate, reverse repo rate)

2. Qualitative, selective or direct (change in the margin money, direct action, moral suasion)

Bank Rate Policy:

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflation has been increasing continuously, it raises the bank rate so borrowing from the central bank becomes costly and commercial banks borrow less money from it (RBI).

The commercial banks, in reaction, raise their lending rates to the business community and borrowers who further borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more.

Investment is encouraged and followed by rise in Output, employment, income and demand and the downward movement of prices is checked.

Open Market Operations:

Open market operations refer to sale and purchase of securities in the money market by the central bank of the country. When prices start rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community or general public.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised so they lend more to business community and general public. It further raises Investment, output, employment, income and demand in the economy hence the fall in price is checked.

Changes in Reserve Ratios:

Under this method, CRR and SLR are two main deposit ratios, which reduce or increases the idle cash balance of the commercial banks. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

Selective Credit Controls:

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them.

a. Change in Margin Money:

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 70% means that the pledger of securities of the value of Rs 10,000 will be given 30% of their value, i.e. Rs 3,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

b. **Moral Suasion:** Under this method RBI urges to commercial banks to help in controlling the supply of money in the economy.

Objectives of the Monetary Policy of India

1. **Price Stability:** Price Stability implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favourable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

2. **Controlled Expansion Of Bank Credit:** One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

3. **Promotion of Fixed Investment:** The aim here is to increase the productivity of investment by restraining non essential fixed investment.

4. **Restriction of Inventories:** Overfilling of stocks and products becoming outdated due to excess of stock often results is sickness of the unit. To avoid this problem the central monetary authority carries out this essential function of restricting the inventories. The main objective of this policy is to avoid over-stocking and idle money in the organization

5. **Promotion of Exports and Food Procurement Operations:** Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

6. **Desired Distribution of Credit:** Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.

7. **Equitable Distribution of Credit:** The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

8. **To Promote Efficiency:** It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.

9. **Reducing the Rigidity:** RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and

diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

Conclusion: So it can be conclude that the implementation of the monetary policy plays a very prominent role in the development of a country. It's a kind of double edge sword, if money is not available in the market as the requirement of the economy, the investors will suffer (investment will decline in the economy) and on the other hand if the money is supplied more than its requirement then the poor section of the country will suffer because the prices of essential commodities will start rising.

RBI ACT 1934 – Important Provisions

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. Some of the important provisions of the act are given below.

Important Provisions of the RBI ACT 1935

SEC 2.E – SCHEDULED BANK: As per this section, a Scheduled bank means a bank whose name is included in the 2nd schedule of the RBI ACT 1934. The essential condition of capital is that such banks have paid-up capital and reserves of not less than □ 25.00 lac. Banks which are not included in the 2nd Schedule of RBI ACT 1934 are called Non-scheduled Bank.

SEC. 17 – TYPES OF BUSINESS: Defines various types of business which RBI may transact, which include acceptance of deposit without interest from Central/State Govt. purchase/sale of forex, securities, rediscounting the bills, P/N, grant loans etc.

SEC 21 – RIGHT TO TRANSACT GOVT BUSINESS: RBI to transact government business in India i.e. remittance, exchange, keeping deposit free of interest etc.

SECT 22 – BANK NOTES: Sole right to issue bank notes.

SEC 23-ISSUE DEPARTMENT: Bank notes shall be issued by issue department against the security of gold coins bullion, rupee coins, foreign securities & other approved securities up to □ 200 crores.

SEC 24-DENOMINATION OF NOTES: RBI issues all currency notes for denomination 2, 5 ,10, 20, 50, 100, 200, 500, 1000, 2000, 5000, 10000.

SEC 28-RULES FOR REFUNDING VALUE: RBI can frame rules for the refunding value of mutilated, soiled or imperfect notes as the matter of grace.

SEC 31 PROHIBITS ISSUE OF BEARER B/E, P/N PAYABLE TO BEARER: No person or entity in India other than RBI or the Central Government is authorized to draw, accept make or issue any bill of exchange, hundi, promissory note, drafts payable or bearer.

SEC 33 – ASSETS OF THE ISSUE DEPARTMENT: The assets of issue department consists of gold coin, gold bullion, foreign securities etc. The aggregate value of gold coin, gold bullion, foreign securities held as assets shall not be less than □ 200.00 crore and □ 115.00 crores respectively.

SEC 42- CASH RESERVE RATIO (CRR): Consequent to GOI'S notification of Sec. of RBI (Amendment) Act 2006 minimum statutory floor and ceiling limit no longer exists. Further, no interest will be payable on CRR balances w.e.f fortnight beginning 31_{st} March 2007. CRR is maintained on fortnightly basis: Saturday to following Friday – 14 days.

SEC 45 A-F COLLECTING & FURNISHING OF CREDIT INFORMATION:

- Borrower enjoying secured credit limit of □ 10.00 lac and above unsecured limits □ 5.00 lac & above: Return as on last Friday of April and October every year. (Half Yearly)
- Doubtful, loss and suit filed accounts with the aggregate of outstanding □ 100 lac and above: Half Yearly March and September
- Basic Statistical Return(BSR): BSR-I regarding borrowal a/cs of above □ 2 lac. BSR-II containing information about deposits with break-up into current, savings & term deposits.

SEC 45 H-T: NBFC: No NBFC shall commence business or carry on the business of a non-banking company without obtaining a certificate of registration and having the net owned fund of □ 25.00 lac or such other amount not exceeding □ 200.00 lac, as the RBI may notify.

SEC 49 – PUBLICATION (DECLARATION) OF BANK RATE: RBI shall make public from time to time the standard rate at which it is prepared to buy re-discount B/E or the other commercial paper eligible for purchase under the Act.

This Banking Regulation guide provides a high level overview of the governance and supervision of banks, including legislation, regulatory bodies and the role of international standards, licensing, the rules on liquidity, foreign investment requirements, liquidation regimes and recent trends in the regulation of banks.

India has several other financial sector regulators, including the:

- Securities Exchange Board of India (SEBI), which is the regulatory authority for the securities market in India.
- Insurance Regulatory and Development Authority of India (IRDAI), which regulates the insurance sector.

- Insolvency and Bankruptcy Board of India (IBBI), which regulates the process relating to conducting insolvency proceedings under the Insolvency and Bankruptcy Code (IBC).

The RBI often liaises closely with the SEBI, IRDAI and, where required, other financial sector regulators, to regulate banking activities which interact with other financial activities.

Banking Regulation Act, 1949

- The **Banking Regulation Act, 1949** came into force on March 16, 1949. It contained various aspects related to banking in India.
- This is regulatory act
- Its purpose is to:
    - Provide safety in the interest of depositors
    - Prevent misuse of powers by managers of banks
- Act does not supersede but supplement to Companies Act, 1956
- Initially named Banking Companies Act, 1949 but from March 1, 1966, the name of the Act was changed to Banking Regulation Act, 1949.
- Initially, the law was applicable only to banking companies. But, 1965 it was amended to make it applicable to cooperative banks and to introduce other changes. Primary Agricultural Credit Society and cooperative land mortgage banks are excluded from the Act. The Act provides a framework using which commercial banking in India is supervised and regulated. The Act supplements the Companies Act, 1956.
- The Act gives the Reserve Bank of India (RBI) the power to license banks, have regulation over shareholding and voting rights of shareholders; supervise the appointment of the boards and management; regulate the operations of banks; lay down instructions for audits; control moratorium, mergers and liquidation; issue directives in the interests of public good and on banking policy, and impose penalties.
- In 1965, the Act was amended to include cooperative banks under its purview by adding the Section 56. Cooperative banks, which operate only in one state, are formed and run by the state government. But, RBI controls the licensing and regulates the business operations. The Banking Act was a supplement to the previous acts related to banking.

Non Performing Asset

When an individual fails to repay or return the money borrowed from a lender, then such kind of a loan becomes nonperforming in the books of financial institutions. There is no guarantee whether a lender can receive the money lent to the borrower.

A **Non Performing Asset** commonly known as NPA refers to the classification for loans on the books of financial institutions that are in default or are in arrears on scheduled payments of principal or interest. It is those assets of the banks which do not bring any return. In most of the cases, debt is classified as nonperforming when an individual does not pay loan which he/she has taken for more than 90 days. 90 days of nonpayment is the standard period of debt to be categorized as nonperforming.

Types of Non Performing Assets

Standard Assets: A Standard asset is one in which the borrower fails to make repayment regularly and on time.

Sub-Standard Assets: A Sub-Standard asset is one which has been NPA for a period not exceeding 12 months. It is an asset in which bank has to maintain 15% of its reserves.

Doubtful Assets: A Doubtful asset is one which has been NPA for more than 12 months.

Loss Assets: A Loss asset is one where the loss has been identified by the bank, through the internal or external auditor or by the central bank inspectors. The amount has not been written off, wholly or partly.

Causes of NPAs

Willful Defaults: A willful defaulter is a person who has defaulted in meeting its payments/repayment obligation to the lender even when it can honor the said obligations. One of the best examples for willful defaults is Kingfisher Airlines Ltd.

Industrial Crisis: It is one of the external factor affecting NPAs in the country. Industries depend on banks to fulfill their requirements on funding their projects. In case of a crisis in the industry, it will change the banking sector, and NPA will rise.

Lenient Lending Norms: Lenient norms by the lender is also one of the prime reasons for rising NPAs. Over analysis of financial status and credit rating by banks for industry-barons are one of the reasons.

Credit distribution Mis-management: Misuse of funds by the borrowers also lead to NPA's. Some borrowers bribe the bank officials and get the loan approved with a sole intention of default.

Scenario in India- Public Sector Banks in India are worst affected with NPA compared with the private sector counterparts. Among the major public sector banks, State Bank of India has the highest amount of NPA at over INR 1.86 lakh crore followed by Punjab National Bank, Bank of India, Bank of Baroda, Canara Bank and Union Bank of India. Among the private sector banks in India, ICICI Bank has the highest amount of NPAs followed by Axis Bank, HDFC Bank, and Jammu & Kashmir Bank, respectively. Effective measures should be taken by the banks and financial institutions to reduce the effects of NPA which dampens the economic growth of banks by poor recycling of funds, which in turn will severely affect the deployment of credit as well as the soundness of the bank.

SARFAESI Act 2002

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 is a legislation that helps financial institutions to ensure asset quality in multiple ways. This means that the Act was framed to address the problem of NPAs (Non-Performing Assets) or bad assets through different processes and mechanisms.

The SARFAESI Act gives detailed provisions for the formation and activities of Asset Securitization Companies (SCs)and Reconstruction Companies (RCs). Scope of their activities, capital requirements, funding etc. are given by the Act. RBI is the regulator for these institutions.

Following are the main objectives of the SARFAESI Act.

- The Act provides the legal framework for securitization activities in India
- It gives the procedures for the transfer of NPAs to asset reconstruction companies for the reconstruction of the assets.
- The Act enforces the security interest without Court’s intervention
- The Act give powers to banks and financial institutions to take over the immovable property that is hypothecated or charged to enforce the recovery of debt.

Major feature of SARFAESI is that it promotes the setting up of asset reconstruction (RCs) and asset securitization companies (SCs) to deal with NPAs accumulated with the banks and financial institutions. The Act provides three methods for recovery of NPAs, viz:

(i) Securitization;

(ii) Asset Reconstruction; and

(iii) Enforcement of Security without the intervention of the Court.

The Act, thus brings three important tools/powers into asset management of financial banks and institutions – securitization of assets, reconstruction of assets and powers for enforcement of security interests (means asset security interests). To understand the SARFAESI Act, we should know the meaning of these terms as well.

What is Securitization?

Securitization is the process of pooling and repackaging of financial assets (like loans given) into marketable securities that can be sold to investors.

In the context of bad asset management, securitization is the process of conversion of existing less liquid assets (loans) into marketable securities. The securitization company takes custody of the underlying mortgaged assets of the loan taker. It can initiate the following steps:

i. Acquisition of financial assets from any originator (bank), and

ii. Raising of funds from qualified institutional buyers by issue of security receipts (for raising money) for acquiring the financial assets or

iii. Raising of funds in any prescribed manner, and

iv. acquisition of financial asset may be coupled with taking custody of the mortgaged land, building etc.

What is asset reconstruction?

Asset reconstruction is the activity of converting a bad or non-performing asset into performing asset. The process of asset reconstruction involves several steps including purchasing of bad asset by a dedicated asset reconstruction company (ARC) including the underlying hypothecated asset, financing of the bad asset conversion into good asset using bonds, debentures, securities and cash, realization of returns from the hypothecated assets etc. Reconstruction, is to be done with the RBI regulations and the SARFAESI Act gives the following components for reconstruction of assets: –

a) taking over or changing the management of the business of the borrower,

b) the sale or lease of a part or whole of the business of the borrower;

c) rescheduling of payment of debts payable by the borrower;

d) enforcement of security interest in accordance with the provisions of this Act;

e) settlement of dues payable by the borrower;

f) taking possession of secured assets in accordance with the provisions of this Act.

What is mean by 'enforcement of security interests'?

The Act empowers the lender (banker), when the borrower defaults, to issue notice to the defaulting borrower and guarantor, calling to repay the debt within 60 days from the date of the notice. If the borrower fails to comply with the notice, the bank or the financial institution may enforce security interests (means interest of the bank/creditor) by following the provisions of the Act:

a) Take possession of the security;

b) Sale or lease or assign the right over the security;

c) Appoint Manager to manage the security;

d) Ask any debtors of the borrower to pay any sum due to the borrower.

If there are more than one secured creditors, the decision about the enforcement of SARFEASI provisions will be applicable only if 75% of them are agreeing.

Government has amended the SARFAESI Act in August 2016 to empower the ARCs (Asset Reconstruction Companies), to rejuvenate Debt Recovery Tribunals (DRTs) and to enhance the effectiveness of asset reconstruction under the new bankruptcy law. The amendment has given more regulatory powers to the RBI on the working of ARCs. It was also aimed to empower asset reconstruction and the functioning of DRTs in the context of the newly enacted bankruptcy law.

Money laundering

Money laundering is the generic term used to describe the process by which criminals disguise the original ownership and control of the proceeds of criminal conduct by making such proceeds appear to have derived from a legitimate source.

Money **Laundering** refers to the conversion of **money** which has been illegally obtained, in such a way that it appears to have originated from a legitimate source. ... In **India**, **money laundering** is popularly known as Hawala transactions

On money laundering, India has been vulnerable and combative, to say in a nutshell. The country has been classified as a high-risk zone in terms of money laundering. Out of 152 countries, India was ranked 79th in the year 2015 and out of 149 countries, India was ranked 78th for the year 2016, by the Anti Money Laundering (AML) Basel Index.

Anti-Money Laundering Laws in India -The successive governments in India, since independence, being aware of the ground realities, have been at various times, proactive in the formulation of laws and legal mechanisms to counter the effects of money laundering and break the existing networks.

In India, before the enactment of the Prevention of Money Laundering Act 2002, a number of statutes addressed scantily the issue in question. These statutes were *The Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974, The Income Tax Act, 1961, The Benami Transactions (Prohibition) Act, 1988, The Indian Penal Code and Code of Criminal Procedure, 1973, The Narcotic Drugs and Psychotropic Substances Act, 1985, The Prevention of Illicit Traffic in Narcotic Drugs and Psychotropic Substances Act, 1988.*

The Prevention of Money Laundering Act, 2002

The Prevention of Money Laundering Act, 2002 or the PMLA is an Act of the Parliament of India enacted to prevent money-laundering and to provide for confiscation of property derived from money-laundering.

The PMLA and the Rules notified there under came into force with effect from July 1, 2005. The Act and Rules notified thereunder impose obligation on banking companies, financial institutions, and intermediaries to verify identity of clients, maintain records and furnish information in prescribed form to the competent authorities formed and appointed in that regard [e.g., Financial Intelligence Unit – India (FIU-IND)]. The Act was subsequently amended in the years 2005, 2009 and 2012.

The Objectives

The PMLA seeks to combat acts pertaining to money laundering in India and in view of this, it mainly has three main objectives:

- To prevent and control money laundering
- To confiscate and seize the property obtained from the laundered money; and
- To deal with any other issue connected with money laundering in India.

Key Concepts in the PMLA

The PMLA, it may be reiterated, is the most exhaustive piece of legislation meant to identify acts and practices pertaining to money laundering and combat the effects thereof. Within its ambit, a number of concepts have been defined, described and dealt with in detail, which would have a direct reference to money laundering activities.

Some of such key-concepts are discussed hereinafter in the following manner.

Money-laundering

The concept of money laundering is described under section 3 of the PMLA, in a manner to include those activities whereby there are ‘attempts to indulge or assist other person’ or become ‘involved in any activity connected with the proceeds of crime and projecting it as untainted property’ are said to be activities which may be acts of money laundering.

Financial Markets

The **financial market** is the market in an economy where funds are exchanged between fund-surplus and fund-scarce individuals and groups. The transaction is based on either interest or dividend. In an economy, this market may have both organised (institutionalised) and unorganised (unregulated/non-institutionalised) segments.

Today, every economy's financial markets are divided into two distinct segments, one catering to the needs of short-term funds and the other to the needs of long-term funds. The **money market** refers to the short-term financial market, whereas the **capital market** refers to the long-term financial market. The money market meets the needs for funds for a period of up to 364 days (i.e., short term), whereas the capital market does the same for a period above365 days (i.e., long term).

What are Financial Markets?

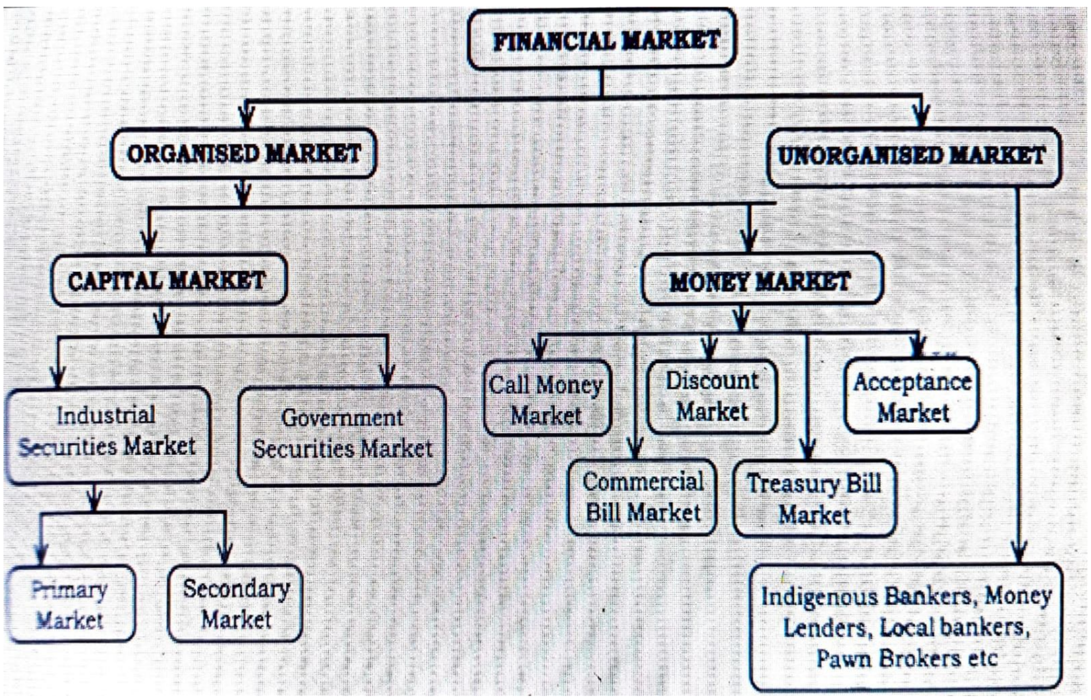
- A financial market is a market where **financial assets** are created and traded.
- Financial markets exist wherever there is a financial transaction.
- Financial transactions may involve the creation of financial assets, such as the initial issue of shares and debentures by a company, or the purchase and sale of existing financial assets, such as stocks.

Concept of Financial Markets

- A business is a component of an economic system that consists of two major sectors: **households** that save money and **business firms** that invest it.
- A financial market facilitates the transfer of funds between savers and investors. It is performing an **allocative function** in doing so.
- It directs or allocates available investment funds to the most productive investment opportunity. When the allocative function is well performed, two things happen:
    - The rate of return offered to households would be higher.
    - Limited resources would be allocated to firms with the highest productivity for the economy.
- **There are two major alternative mechanisms for allocating funds: banks and financial markets.**

- Households can deposit their excess funds with banks, which can then lend them to businesses. Alternatively, households can use financial markets to purchase a company's shares and debentures.
- The process of allocating funds is known as **financial intermediation**.
- Banks and financial markets compete as intermediaries in the financial system, giving households the option of where to invest their savings.

Types of Financial Markets



Financial markets are divided into two types:

1. **Organised Markets**

- These are financial markets that operate in accordance with the laws, rules, and regulations enacted by the government and overseen by the central bank of the country (RBI) or another regulatory body.
- Financial markets that are organised are further classified as:
  - **Money Markets** - The money market is primarily concerned with short-term credit transactions.
  - **Capital Markets** - The capital market is concerned with medium and long-term credit and financial transactions.

2. **Unorganised Markets**

- Unorganized markets are those that are not governed or controlled by the central bank, and they primarily consist of money lenders, indigenous bankers, and others who provide credit to the public.

Financial Markets – Functions

1. **Mobilization of Savings**

- A financial market facilitates the transfer of savings from savers to investors.
- It provides savers with a variety of investment options, assisting in the allocation of surplus funds to the most productive use.

2. **Facilitating Price Discovery**

- Households are the suppliers of funds in the financial market, while businesses are the demand.
- Their interaction contributes to the establishment of a price for the financial asset traded in that market.

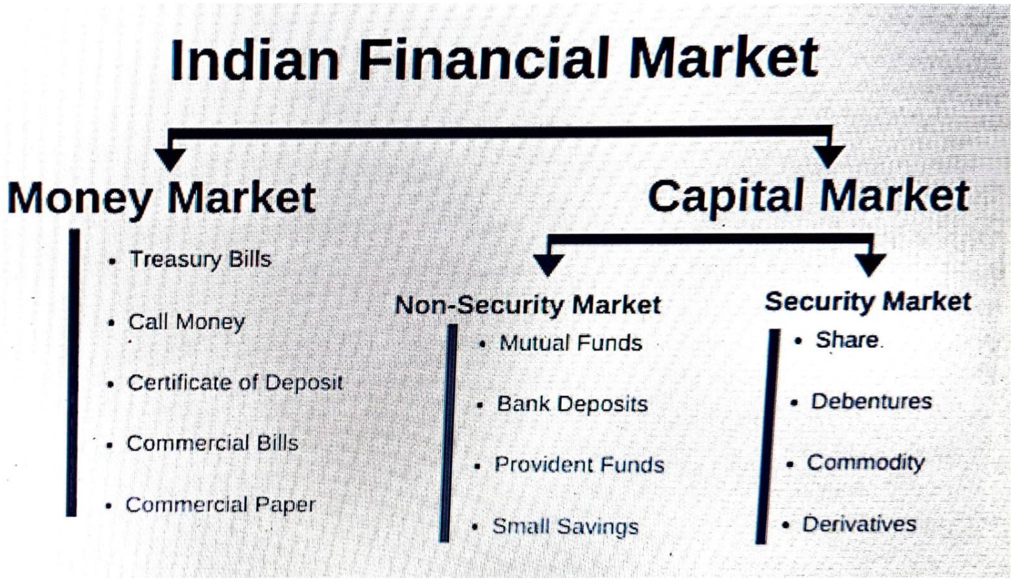
3. **Providing Liquidity to Financial Assets**

- Financial markets make it simple to buy and sell financial assets.
- As a result, they provide liquidity to financial assets, allowing them to be easily converted into cash when needed.
- Asset holders can easily sell their financial assets using the financial market's mechanism.

4. **Reducing Transaction Costs**

- Financial markets provide valuable information about the securities that are traded in the market.
- It saves time, effort, and money that both buyers and sellers of a financial asset would otherwise have to spend trying to find each other.
- As a result, the financial market serves as a common platform where buyers and sellers can meet to fulfiltheir individual needs.

Financial Markets Instruments



There are various types of Financial Instruments available in the market, such as:

Money Market Instruments

- Treasury Bills
- Call Money
- Certificate of Deposit
- Commercial Bills
- Commercial Paper

Capital Market Instruments

There are three types of capital market instruments:

- **Pure Instruments –** They are pure and don't have anything in common. **Shares, bonds, and debentures** are examples of pure instruments.
- **Hybrid instruments –** They have a combination of characteristics, such as a **bond and an equity investment**.
- **Derivatives –** These instruments have no intrinsic value and are derived from one or more financial assets. **Futures and options** are two examples of derivatives.

Stock Exchanges

- A stock exchange is an organisation that provides a marketplace for the purchase and sale of existing securities.
- The stock exchangefacilitates the conversion of a security (share, debenture, etc.) into money and vice versa.
- Stock exchanges assist companies in raising capital, providing liquidity and investment security to investors, and improving individual companies' creditworthiness.

- The **Securities Contracts (Regulation) Act of 1956** defines a stock exchange as **"anybody of individuals, whether incorporated or not, established for the purpose of assisting, regulating, or controlling the business of buying and selling or dealing in securities."**
- The efficient operation of a stock exchange fosters an active and expanding primary market for new issues.

Conclusion

- Financial markets facilitate the efficient flow of investments and savings in the economy and the expansion of funds for the production of goods and services.
- The right mix of financial products and instruments, as well as financial markets and institutions, fuels the demands of investors, receivers, and a country's overall economy.
- Investors can specialise in specific services and markets by using financial markets (bonds and stocks), instruments (derivatives, bank CDs, and futures), and institutions (banks, pension funds, insurance companies, and mutual funds).

UNIT 2

Meaning of Commercial Banks

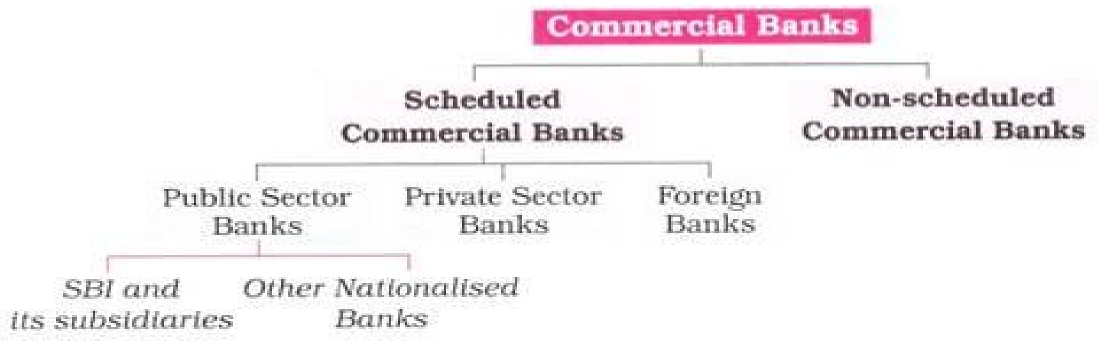
Commercial banks are the most important components of the whole banking system.

A commercial bank is a profit-based financial institution that grants loans, accepts deposits, and offers other financial services, such as overdraft facilities and electronic transfer of funds.

According to Culbertson,

“Commercial Banks are the institutions that make short make short term bans to business and in the process create money.”

In other words, commercial banks are financial institutions that accept demand deposits from the general public, transfer funds from the bank to another, and earn profit.



Scheduled Banks and Non-scheduled Banks:

Commercial banks are classified in two broad categories—scheduled banks and non-scheduled banks.

Scheduled banks are those banks which are included in Second Schedule of Reserve Bank of India. A scheduled bank must have a paid-up capital and reserves of at least Rs 5 lakh. RBI provides special facilities including credit to scheduled banks. Some of important scheduled banks are State Bank of India and its subsidiary banks, nationalised banks, foreign banks, etc.

Non-scheduled Banks:

The banks which are not included in Second Schedule of RBI are known as non-scheduled banks. A non-scheduled bank has a paid-up capital and reserves of less than Rs 5 lakh. Clearly, such banks are small banks and their field of operation is also limited.

Functions of Commercial Banks:

Commercial banks are institutions that conduct business for profit motive by accepting public deposits for various investment purposes.

The functions of commercial banks are broadly classified into primary functions and secondary functions, which are shown in Figure-1:

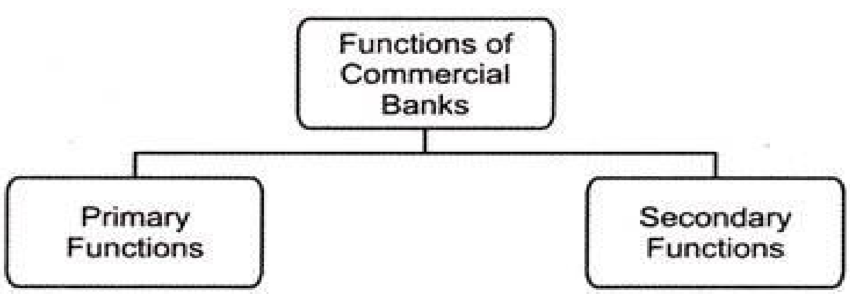


Figure-1: Functions of Commercial Banks

Primary Functions:

Refer to the basic functions of commercial banks that include the following:

<u>1-Accepting Deposits:</u> Implies that commercial banks are mainly dependent on public deposits.

Deposits are of three types as under:

(i) Current account deposits:

Such deposits are payable on demand and are, therefore, called demand deposits. These can be withdrawn by the depositors any number of times depending upon the balance in the account. The bank does not pay any Interest on these deposits but provides cheque facilities. These accounts are generally maintained by businessmen and Industrialists who receive and make business payments of large amounts through cheques.

(ii) Fixed deposits (Time deposits):

Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheque facilities.

They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

(iii) Savings account deposits:

These are deposits whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits. They are payable on demand and also withdraw able by cheque. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account deposits in lesser than that of fixed deposit.

Difference between demand deposits and time (term) deposits:

Two traditional forms of deposits are demand deposit and term (or time) deposit:

(i) Deposits which can be withdrawn on demand by depositors are called demand deposits, e.g., current account deposits are called demand deposits because they are payable on demand but saving account deposits do not qualify because of certain conditions on withdrawal. No interest is paid on them. Term deposits, also called time deposits, are deposits which are payable only after the expiry of the specified period.

(ii) Demand deposits do not carry interest whereas time deposits carry a fixed rate of interest.

(iii) Demand deposits are highly liquid whereas time deposits are less liquid,

(iv) Demand deposits are chequable deposits whereas time deposits are not.

2-Making Advances : The commercial banks provide loans and advances of various forms. It includes an over draft facility, cash credit, bill discounting, etc. They also give demand and demand and term loans to all types of clients against proper security.

3-Credit creation : It is most significant function of the commercial banks. While sanctioning a loan to a customer, a bank does not provide cash to the borrower Instead it opens a deposit account from where the borrower can withdraw. In other words while sanctioning a loan a bank automatically creates deposits. This is known as a credit creation from commercial bank.

Secondary Functions:

Refer to crucial functions of commercial banks. The secondary functions can be classified under three heads, namely, agency functions, general utility functions, and other functions.

These functions are explained as follows:

(1) Agency Functions:

Implies that commercial banks act as agents of customers by performing various functions, which are as follows:

(i) Collecting Checks:

Refer to one of the important functions of commercial banks. The banks collect checks and bills of exchange on the behalf of their customers through clearing house facilities provided by the central bank.

(ii) Collecting Income:

Constitute another major function of commercial banks. Commercial banks collect dividends, pension, salaries, rents, and interests on investments on behalf of their customers. A credit voucher is sent to customers for information when any income is collected by the bank.

(iii) Paying Expenses:

Implies that commercial banks make the payments of various obligations of customers, such as telephone bills, insurance premium, school fees, and rents. Similar to credit voucher, a debit voucher is sent to customers for information when expenses are paid by the bank.

(2) General Utility Functions:

Include the following functions:

(i) Providing Locker Facilities:

Implies that commercial banks provide locker facilities to its customers for safe keeping of jewellery, shares, debentures, and other valuable items. This minimizes the risk of loss due to theft at homes.

(ii) Issuing Traveler's Checks:

Implies that banks issue traveler's checks to individuals for traveling outside the country. Traveler's checks are the safe and easy way to protect money while traveling.

(iii) Dealing in Foreign Exchange:

Implies that commercial banks help in providing foreign exchange to businessmen dealing in exports and imports. However, commercial banks need to take the permission of the central bank for dealing in foreign exchange.

(iv) Transferring Funds:

Refers to transferring of funds from one bank to another. Funds are transferred by means of draft, telephonic transfer, and electronic transfer.

(3) Other Functions:

Include the following:

(i) Creating Money:

Refers to one of the important functions of commercial banks that help in increasing money supply. For instance, a bank lends Rs. 5 lakh to an individual and opens a demand deposit in the name of that individual.

Bank makes a credit entry of Rs. 5 lakh in that account. This leads to creation of demand deposits in that account. The point to be noted here is that there is no payment in cash. Thus, without printing additional money, the supply of money is increased.

(ii) Electronic Banking:

Include services, such as debit cards, credit cards, and Internet banking.

Types of Credit Offered by Commercial Banks:

A commercial bank offers short-term loans to individuals and organizations in the form of bank credit, which is a secured loan carrying a certain rate of interest.

There are various types of bank credit provided by a commercial bank, as shown in Figure-2:

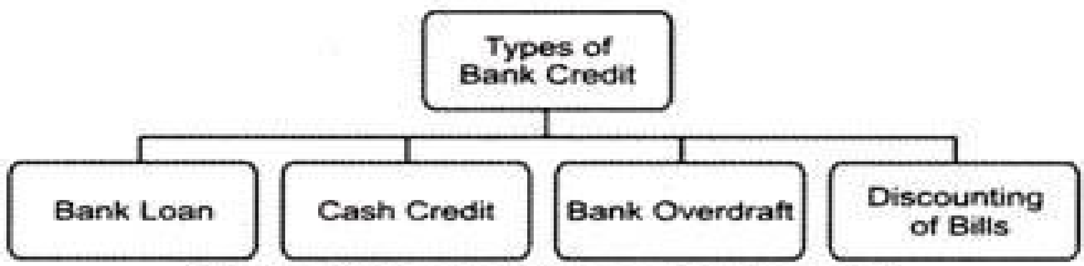


Figure-1: Showing Types of Bank Credit

Bank Loan:

Bank loan may be defined as the amount of money granted by the bank at a specified rate of interest for a fixed period of time. The commercial bank needs to follow certain guidelines to extend bank loans to a client. For example the bank requires the copy of identity and income proofs of the client and a guarantor to sanction bank loan. The banks grant loan to clients against the security of assets so that, in case of default, they can recover the loan amount. The securities used against the bank loan may be tangible or intangible, such as goodwill, assets, inventory, and documents of title of goods.

The advantages of the bank loan are as follows:

a. Grants loan at low rate of interest

b. Involves very simple process of loan granting

c. Requires minimum document and legal formalities to pass the loan

d. Involves good customer relationship management

e. Consumes less time because of modern techniques and computerization

f. Provides door-to-door facilities

In addition to advantages, the bank loan suffers from various imitations, which are as follows:

a. Imposes heavy penalty and legal action in case of default of loan

b. Charges high rate of interest, if the party fails to pay the loan amount in the allotted time

c. Adds extra burden on the borrower, who needs to incur cost in preparing legal documents for procuring loans

d. Affects the goodwill of the organization, in case of delay in payment

Cash Credit:

Cash credit can be defined as an arrangement made by the bank for the clients to withdraw cash exceeding their account limit. The cash credit facility is generally sanctioned for one year but it may extend up to three years in some cases. In case of special request by the client, the time limit can be further extended by the bank.

The extension of the allotted time depends on the consent of the bank and past performance of the client. The rate of interest charged by the bank on cash credit depends on the time duration for which the cash has been withdrawn and the amount of cash.

The advantages of the cash credit are as follows:

a. Involves very less time in the approval of credit

b. Involves flexibility as the cash credit can be extended for more time to fulfill the need of the customers.

c. Helps in fulfilling the current liabilities of the organization

d. Charges interest only on the amount withdrawn by the customer. The interest on cash credit is charged only on the amount of cash withdrawn from the bank, not on the total amount of credit sanctioned.

The cash credit is one of the most important instruments of short-term financing but it has some limitations.

These limitations are mentioned in the following points:

a. Requires more security for the approval of cash

b. Imposes very high rate of interest

c. Depends on the consent of the bank to extend the credit amount and the time limit

Bank Overdraft:

Bank overdraft is the quickest means of the short-term financing provided by the bank. It is a facility in which the bank allows the current account holders to overdraw their current accounts by a specified limit. The clients generally avail the bank overdraft facility to meet urgent and emergency requirements. Bank overdraft is the most popular form of borrowing and do not require any written formalities. The bank charges very low rate of interest on bank overdraft up to a certain time.

The advantages of the bank overdraft are as follows:

a. Involves no documentation for the extension of overdraft amount

b. Imposes nominal interest on the overdraft amount

c. Charges fee only on the amount exceeding the account limit

The disadvantages of the bank overdraft are as follows:

a. Incurs high cost for the clients, if they fail to pay the amount of overdraft for a longer period of time

b. Hampers the reputation of the organization, if it fails to pay the amount of overdraft on time

c. Allows the bank to deduct overdraft amount from the customers' accounts without their permission

Discounting of Bill:

Discounting of bill is a process of settling the bill of exchange by the bank at a value less than the face value before maturity date. According to Sec. 126 of Negotiable Instruments, "a bill of exchange is an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at fixed or determinable future time a sum certain in money to order or to bearer."

The facility of discounting of bill is used by the organizations to meet their immediate need of cash for settling down current liabilities.

Conditions laid down by the bank for discounting of bill are as follows:

a. Must be intended to specific purpose

b. Must be enclosed with the signature of the two persons (company, bank or reputed person)

c. Must be less than the face value

d. Must be produced before the maturity period.

Special Relationship between the Banker and Customer

What is a Banker?

According to Section 3 of the Negotiable Instruments Act the term ‘banker’ includes any person acting as a banker.

According to Halsbury’s Laws of England a banker as “an individual, partnership or corporation whose sole predominating business is banking, that is the receipt of money on current account or deposit account and the payment of cheques drawn by and the collection of cheques paid in by the customer.”

A banker is one who in the ordinary course of his business, honors cheques drawn upon him by persons from and for whom he receives money on their account. No person or body corporate can be a banker who does not (1) take deposit accounts and current accounts, (2) issue and pay cheques and (3) collect cheques crossed and uncrossed for its customers. One claiming to be a banker must acknowledge himself to be one, and the public must accept him as such; his main business must be that of banking from which normally he should be able to earn his livelihood.

What is a Customer?

A customer is a person who has some kind of account, such as deposit or current with a bank and from this it follows that any person may become a customer by opening a deposit or current account or having some similar relation with a bank.”

To constitute a customer, there must be some identifiable course or habit of dealing in the nature of regular banking business. It is difficult to settle the idea of a single transaction with that of a customer.   A customer is a person; he should have some kind of an account with the bank. The initial transaction in opening an account will not create the relation of a banker and customer. According to the ‘duration theory’ the relation of a banker and customer begins as soon as the first cheque is paid in and accepted for collection.

In simple words a customer can be any person for whom the bank agrees to conduct an account.

Legal Requirements to be qualified as Customer:

- Customer should be a major
- Customer be of sound mind
- He should not be debarred under any law
- There must be an offer and acceptance of the proposal.

Things to be noted:

- A single transaction can constitute a customer

- Every customer should have an account
- There should be some frequency in transactions
- All the dealing must be of banking nature
- The customer can be a person, a company, a society or a legal entity.

Special Relationship between the Banker and Customer-

Bellow given are the general relationship between a banker and customer

- Debtor – Creditor
- Creditor – Debtor
- Principal – Agent
- Bailor – Bailee
- Trustor – Trustee
- Pledger – Pledgee
- Mortgagor – Mortgagee

Debtor and Creditor Relationship

When customer deposits money with a bank the relationship of debtor and creditor will be established, in this case Banker is the Debtor and Customer is the Creditor. It is the basic rule of banking law that in the case of a general deposit of money in the bank, the moment the money is deposited it becomes the property of bank; here the bank and the depositor assume the legal relation of debtor and creditor.

Creditor and Debtor

When a bank grants loan and other credit facilities to the customer, the relationship between the banker and customer is reversed, that is Customer is Debtor and Banker is Creditor. In such cases banker doesn't carry/ hold the money of the customer but it is the money of the bank in the hands of the customer. In all such cases when a customer's account is over drawn, the customer does not cease to be a customer.

Principal and Agent

In some situations, the banker serves as agent of the customer (principal). Some of the agency activities of a banker are specified below:

- Collecting cheques on behalf of the customer
- Collecting dividends and bills of exchange
- Acting as an attorney, representative or executor of a customer
- Buying and selling securities on behalf of his customer.

Duties of the Agent (Banker):

Some of the important duties of an agent are given below:

- To follow the instructions given by principal
- To show required skill and carefulness
- Duty to provide proper accounts
- Duty to pass on any benefits derived from agency

Duties of Principal (customer):

- The principal should pay remuneration to the agent
- The principal should not prevent his agent from performing the duties/ acts assigned to him under the contract and for which remuneration is payable.
- Any lawful expenses which have been incurred by the agent in the course of performance of his duties are to be indemnified by the principal.

Bailor and Bailee Relationship:

Bailment is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is fulfilled, be returned or disposed of according to the directions of the person delivering them. The person delivering the goods is called the “bailor” and the person to whom these are delivered is called the “bailee”.

Bailment is also an important type of relations between the banker and customer. It may arise in the following situations:

- Availing safe custody services (lockers)
- Pledge of stocks as security for availing credit from bank

In these cases Customer is the Bailor and the Bank is the Bailee

Pledger and Pledgee Relationship

Pledge means the bailment of goods as security for payment of a debt or performance of a promise. When credit facility is provided by a bank to its customers against collateral security of movable property, the Relationship of Pledger and Pledgee is established.

In this case customer is the Pledger and banker is the pledgee.

Mortgagor and Mortgagee Relationship

Mortgage means the transfer of an interest in specific immoveable property for the purpose of getting the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a financial liability.

When credit facility is provided by the bank to a customer against the security of immovable property, the relationship of Mortgagor and Mortgagee is established.

In this situation:

- Mortgagor— Customer
- Mortgagee— Bank

Rights of A banker

Following are the rights of a banker:

1. Right of general lien:

Lien is a right to keep possession of a property belonging to someone else until that person discharges the debt they owe you. As such, lien gives the banker a right to retain assets, securities or goods, pledged as securities/collateral belonging to the clients/borrower until the borrower repays the loan/debt. The right of general lien is conferred on the bankers by Section 171 of the Indian Contract Act.

A banker should exercise his right of general lien only as a banker not as a bailee. Also, the banker can sell or realize the collateral/security only after giving a reasonable notice to the customer who has defaulted. Banks cannot realize valuables deposited with them for safe custody. This is a case of bailment. Hence, the bank cannot exercise the right of general lien in case of bailments.

A banker cannot exercise the right of general lien in the following cases:

a. If valuables are deposited for safe custody

b. If money or documents are deposited for specific purposes

c. If there is an express agreement that the bank shall not exercise this right.

2. The Right of Set-off:

Right of set-off gives the banker the power to adjust the amounts due to them from a customer, against the amount payable by the customer to the banker. This helps in determining the net balance payable by one party to another. If a customer has two or more accounts by the same name in a bank, the banker has the right to set-off the amounts in both the accounts. In other words, the banker has a right to combine two accounts.

3. Right of Appropriation:

A customer may owe several distinct debts to the bank. When the customer deposits some money in the bank without specific instructions and the amount is not sufficient to discharge all debts, then the problem arises as towards which debt this amount should be adjusted. In the absence of any specific instructions, the bank has the right to appropriate the deposited amount to any loan, even to a time barred-debt. But the banker must inform the customer about the appropriation.

4. Right to charge interest and commission:

A banker has a right to charge interest on loans and advances. A bank also has the right to charge a commission for services that it renders to clients. Such services can be SMS notification services, retail banking, multi-city cheque service, etc. Such charges can be debited to the customer's account.

5. Right to close the account:

The banker has the right to close an account, if it is of the opinion that an account is not being operated properly. It may do so only by sending a written intimation to the customer.

Duties of bankers:

The most important duty of a banker is to help their clients with all their financial queries and needs. The banker may do so by meeting their clients in person or speaking with them over the phone.

Following are the duties of a banker:

1. Review client's history:

The banker must review their clients' financial history and current financial position.

2. Advise clients:

Reviewing a client's history helps the banker learn about the customer's desired financial needs. The banker should assist and guide them to meet their financial goals.

3. Keep records:

The banker has to maintain complete and check records of the bank's transactions on a daily basis. Documents such as loan applications, bank statements and so on, must be reviewed and filed by the banker.

4. Gather financial information:

A banker should gather financial information from both new and existing clients. A banker should speak with the clients and use the information gathered to prepare accounts, loans and determine their creditworthiness.

5. Disbursal of funds:

A banker must withdraw and deposit funds. This requires a lot of attention and accuracy.

Cheque

Cheques are common forms of negotiable instruments. If you have a savings bank account or a current account at a bank, you can issue a cheque in your name or in favour of other people like a client, thereby directing the bank to pay a specific amount to the persons named in the cheque.

A cheque is a financial instrument issued by the bank to an account holder to make certain payments to an individual or company. A customer can use a cheque instead of hard cash to make payments. It is a trusted form of making payments, as only the recipient named is able to withdraw money by encashing the cheque at the bank, provided he/she proves their identity.

At the bottom of the cheque there is some information in the MICR format. This is a machine readable information system that is encrypted and enables automated routing and sorting of cheques and automated clearing facilities. The payee can deposit the cheque at their own bank branch or some other bank from where it would be routed back to the originating bank and enable the transfer of funds to the account that is mentioned in the cheque.

Types Of Cheques

A cheque is written by an individual or an organisation for large payments. Unlike cash, cheque payments are recorded with the bank and reflect in your bank account. But what is a cheque?

A cheque is a document that tells your bank to transfer the mentioned amount to a person or organisation. There are mainly ten types of cheques in India that you should know about.” The ten types of cheques include:

1. Bearer Cheque

A bearer cheque is the type of cheque that allows the person bearing or carrying the cheque to the bank to receive the payment specified on the cheque. These cheques have the words “or bearer” printed in front of the name of the payee. It means that the amount of the cheque issued can be either received by the payee or the bearer. It also makes a bearer cheque transferable, as anyone who is carrying it can receive the payment. The bank need not request the authorisation of the issuer to make the payment of this cheque.

2. Order cheque

The second type of cheque is the order cheque. An order cheque is the one that has the words "or bearer" cancelled out. It means that only the individual whose name is mentioned as the payee can receive the specified sum of money. In this case, the bank does not check the bearer's identity before making the payment.

3. Crossed cheque

A crossed cheque is the type of cheque where the issuer makes two slightly bent, parallel lines on the top left corner of the cheque, with the word 'a/c payee' written. It means that the specified sum of the cheque, regardless of who is handing it over, will only be transferred to the individual/organisation whose name is mentioned as the payee. A crossed cheque is also safer because it can be cashed only at the payee's bank

4. Open cheque

An open cheque does not have the crossed lines, and hence, is also called an uncrossed cheque. An open cheque can be cashed at either of the banks, namely, the payer's bank or the payee's bank. Also, an open cheque is transferable by the payee, which means they can make someone else the payee. The issuer of the open cheque is required to sign on both the front and back of the cheque.

5. Post-dated cheque

A post-dated cheque bears a date later than the date it was issued on. It can only be cashed after the date specified by the payer. The post-dated cheque can be valid after the mentioned date but not before it. Hence, even if it is presented to the bank, the bank will not process it until the mentioned date.

6. Stale cheque

A stale cheque has already passed its validity date and can no longer be cashed. Currently, a cheque is considered valid until three months from its issued date.

7. Traveller's cheque

Issued by a bank, a traveller's cheque can be cashed by the payee at another bank in another country. The payment will be received in that country's currency. It becomes useful when you are heading on a foreign trip and do not wish to carry too much cash. A traveller's cheque does not have an expiry date.

8. Self cheque

A self cheque has the word 'self' written as the payee. It is used by the issuer to withdraw money from their **bank account**. A self cheque can be cashed only at the issuer's bank.

9. Banker's cheque

A banker's cheque is issued by the bank itself. A bank issues a banker's cheque on behalf of an account holder to issue payment to another person in the same city. Banker's cheques are only valid for three months, however, post their validity period they can be revalidated if certain conditions are fulfilled.

10. Blank cheque

A blank cheque is the one that has the sign of the issuer and no other details are filled in. Blank cheques pose a high risk because if lost, anyone who finds it can fill in any amount and issue it to themselves.

11-Mutilated Cheque:

When a cheque is torn into two or more pieces and presented for payment, such a cheque is called a mutilated cheque. The bank will not make payment against such a cheque without getting confirmation from the person who has written the cheque.

12-Ante Dated Cheque:

Ante means prior. Antedated cheque means the date mentioned on the cheque is earlier than the actual date of withdrawing the money. An antedated cheque is a regular cheque that can be encashed without delay. So any cheque can be presented to the bank for clearance, however the date should not exceed 3 months. Ante-dated cheques can be used when the contract is delayed, to avoid unnecessary trouble to a party.

How to write a cheque?

Writing a cheque is simple and easy. But sometimes, people make careless mistakes while writing a cheque, that can result in fraud or the cheque being misused or dishonored. The process becomes natural with successive writing. For first timers, here's a guide on how to write a cheque:

1. **Write the date**: mention the date on the top right corner next to a box or line that says ‘date’. There is a specified space for you to write the date. Always write the same date that you signed the cheque on.

1. **Write the recipient:** write the name of the recipient on the line that contains ‘pay’ written before it. Try not to leave any spaces between ‘pay’ and the name of the recipient. This will reduce chances of misuse of the cheque, by adding alphabets before or after the name. Always strike out spaces after writing the name and start as close as possible to the words ‘PAY’ and leave just the bare minimum spacing in-between names.
2. **Write the amount:** write the amount that must be paid to the recipient from your account. Write the amount in words as well as in numbers, in the respective spaces provided. Always write ‘only’ after the amount written in words and use the symbol ‘/- ‘after writing the amount in numbers. If you do not follow the above and leave additional space between amounts and ‘only’ or /- then amounts can be easily altered by fraudsters and additional letters and numbers can be entered. Also strike out the empty space left.
3. **Sign the cheque:** At the bottom right corner there a space for you to sign the cheque. The signature is a must as the name of the account holder proves that the cheque is valid. Do not sign on the MICR band as it may lead to your cheque getting dishonored.
4. **Fill the memo section:** The cheque book usually comes with a section for all this information at the back. Fill in the details and keep it handy to cross-check any suspicious activity, future records, or a possible fraud.

Importance of cheques:

There are a number of reasons why the offline method of cheque payment is still widely used. The main advantages of using cheques are listed below:

1. Cheque can only be encashed by the recipient of the cheque at a financial institution.
2. This is a traditional method of payment that has been around for a long time. People trust this method over online payments, mobile wallets and other digital services.
3. The customers can issue a post dated cheque. This allows the customer to buy time to deposit funds into the account. This enables customers pay in advance for goods or services, even if they do not have sufficient funds in their accounts.
4. Each cheque creates a paper document that details who received the payment, what day the payment was made and so on.
5. Maintains confidentiality of your account and guarantees payment to the payee.

Cheque book request:

Cheque book issuing request can be made through online or offline method.

1. **Offline method:** The customer can visit the bank and submit a written application, addressing the branch manager along with details of the account.

2. **Online method:** to apply online, a customer has to log on to the retail section of the internet banking site and select the cheque book option. The customer needs to select the account, on

which the cheque book will be issued, enter the number of cheque leaves required and the mode of delivery.

Dishonoured cheque

Normally when the cheque deposited by anybody for collection or presented for payment at the teller counter, the banker makes payment of the cheque subject to several conditions.

When the cheque is returned by the banker for anyone or more reasons by the banker, it is known as dishonour and the cheque thus dishonoured is known as dishonoured cheque

Dishonour also known as bouncing or returning

It can be also called as dishonoured cheque or bounced cheque or returned cheque

Cheques are returned by the banker for the following reasons:

- In sufficient funds - when there is no sufficient balance in the account for making payment of the cheque
- Stale cheque - when the date of the cheque is beyond the validity period of three months
- Post dated cheque - when the date of presentation of the cheque is one or more days earlier than the date of the cheque
- Mutilated cheque - a damaged cheque on account of fire, water, ink, paints or some piece of the cheque is missing
- Ante dated cheque - when the cheque bears more than one date out of which the date of the cheque is either a stale cheque or post dated
- Crossed to two banks - when the cheque bears more than one special crossing in favour of two banks
- Property not marked - when the seal of the firm is missing in respect of cheques drawn by firms
- Exceeds arrangement - in the case of overdraft accounts, the limit is not sufficient to make payment of the cheque

Types Of Bank Accounts

Whether you are a housewife or a college student, a business owner or a business house, a retired professional or Indian living abroad, not having a bank account is unimaginable. Based on the purpose, frequency of transaction, and location of the account-holder, banks offer a bouquet of bank accounts to choose from. Here is a list of some of the **types of bank accounts in India**.

1. Current account = A current account is a deposit account for traders, business owners, and entrepreneurs, who need to make and receive payments more often than others. These accounts hold more liquid deposits with no limit on the number of transactions per day. Current accounts allow overdraft facility, that is withdrawing more than what is currently available in the account. Also, unlike savings accounts, where you earn some interest, these are zero-interest bearing **accounts**. You need to maintain a minimum balance to be able to operate current accounts.

2. Savings account = A savings bank account is a regular deposit account, where you earn a minimum rate of interest. Here, the number of transactions you can make each month is capped. Banks offer a variety of Savings Accounts based on the type of depositor, features of the product, age or purpose of holding the account, and so on.

3. Salary account = Among the different types of **bank accounts**, your salary account is the one you have opened as per the tie-up between your employer and the bank. This is the account, where salaries of every employee are credited to at the beginning of the pay cycle. Employees can pick their type of salary account based on the features they want. The bank, where you have a salary account, also maintains reimbursement accounts; this is where your allowances and reimbursements are credited to.

4. Fixed deposit account = To park your funds and earn a decent rate of interest on it, there are **different types of accounts** like fixed deposits and recurring deposits.

A fixed deposit (FD) account allows you to earn a fixed rate of interest for keeping a certain sum of money locked in for a given time, that is until the FD matures. FDs range between a maturity period of seven days to 10 years. The rate of interest you earn on FDs will vary depending on the tenure of the FD. Generally, you cannot withdraw money from an FD before it matures. Some banks offer a premature withdrawal facility. But in that case, the interest rate you earn is lower.

5. Recurring deposit account = A recurring deposit (RD) has a fixed tenure. You need to invest a fixed sum of money in it regularly -- every month or once a quarter -- to earn interest. Unlike FDs, where you need to make a lump sum deposit, the sum you need to invest here is smaller and more frequent. You cannot change the tenure of the RD and the amount to be invested each month or quarter. Even in the case of RDs, you face a penalty in the form of a lower interest rate for premature withdrawal. The maturity period of an RD could range between six months to 10 years.

6. NRI accounts = There are **different types of bank accounts** for Indians or Indian-origin people living overseas. These accounts are called overseas accounts. They include two types of savings accounts and fixed deposits -- NRO or non-resident ordinary and NRE or non-resident external accounts. Banks also offer foreign currency non-resident fixed deposit accounts. Let us quickly see the **various types of bank accounts** for NRIs-

a) Non-resident ordinary (NRO) savings accounts or fixed deposit accounts = NRO accounts are rupee accounts. When NRIs deposit money in these accounts, usually in foreign currency, it is converted into INR at the prevailing exchange rate. NRIs can park money earned in India or overseas in NRO bank accounts. Payments like rent, maturities, pension, among others, can be sent abroad through NRO accounts. The income earned on these deposit accounts is taxed.

b) Non-resident external (NRE) savings accounts or fixed deposit accounts = NRE deposit accounts are similar to NRO accounts and the funds in these accounts are maintained in INR. Any money deposited into these accounts is converted into INR at prevailing exchange rates. But, these accounts are only for parking your earnings from abroad. The funds, both principal and interest, are transferable. But, the interest earned on these deposit accounts is not taxed in India.

C) Foreign currency non-resident (FCNR) account = As the name suggests and unlike the other two types of bank accounts, FCNR accounts are maintained in foreign currency. The principal and interest from these accounts are transferable, but the interest earned is not taxed in India.

Time Value of Money

The time value of money (TVM) is a basic financial principle describing how money in the present is worth more than an equal amount in the future. As the old saying goes, "A dollar today is worth more than a dollar tomorrow."

Let's say you are the lucky winner of a $1 million lottery, and you are presented with two options: A lump sum payment *right now* worth $1 million or 10 annual payments of $100,000 each (totaling $1 million over that span of time). Excluding any tax ramifications, which is the better option?

TVM tells us option one -- the lump sum payment *right now* -- is best because it gives you the ability to put the money to work earning interest or growing via some other investment vehicle like stocks or real estate.

Why is the time value of money important?

Whether you are managing your own finances or determining your investing strategy, TVM is an important concept to comprehend. One critical factor is inflation -- the effect that causes everything to rise in price over time. A **McDonald's** (NYSE:MCD) hamburger cost just $0.15 back in 1970. Fast-forward 50 years, a burger is going to cost a buck or two, depending on where you live. Your $0.15 was worth much more half a century ago than it's worth today. But what can counteract the negative impacts of inflation? Investing.

TVM could help your money keep up with -- even exceed -- the rate of inflation, since interest and investment returns compound in value over time. Let's say you earn $1 on $100 in your high-yield savings account (yielding 1% a year). Next year you will earn $1.01 because the first

$1 in interest you made is now also earning interest. This same concept works in investing. If your $100 gains 10% in year one (boosting your portfolio value to $110), you will earn $11 in year two if you gain another 10% (since the first $10 made will also gain 10% in value). That might not sound like much in the early stages, but compounding really adds up.

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The formula for the time value of money

Time Value of Money

$$FV = PV(1+r)^n$$

$$PV = \frac{FV}{(1+r)^n}$$

Negotiable Instruments – Meaning, Types & Uses

Negotiable Instruments are written contracts whose benefit could be passed on from its original holder to a new holder. In other words, negotiable instruments are documents which promise payment to the assignee (the person whom it is assigned to/given to) or a specified person. These instruments are transferable signed documents which promises to pay the bearer/holder the sum of money when demanded or at any time in the future.

As mentioned above, these instruments are transferable. The final holder takes the funds and can use them as per his requirements. That means, once an instrument is transferred, holder of such instrument obtains a full legal title to such instrument.

Types of Negotiable Instruments

Promissory notes

A promissory note refers to a written promise to its holder by an entity or an individual to pay a certain sum of money by a pre-decided date. In other words, Promissory notes show the amount which someone owes to you or you owe to someone together with the interest rate and also the date of payment.

For example, A purchases from B INR 10,000 worth of goods. In case A is not able to pay for the purchases in cash, or doesn't want to do so, he could give B a promissory note. It is A's promise to pay B either on a specified date or on demand.
In another possibility, A might have a promissory note which is issued by C. He could endorse this note and give it to B and clear of his dues this way. However, the seller isn't bound to accept the promissory note. The reputation of a buyer is of great importance to a seller in deciding whether to accept the promissory note or not

Bill of exchange

Bills of exchange refer to a legally binding, written document which instructs a party to pay a predetermined sum of money to the second(another) party. Some of the bills might state that money is due on a specified date in the future, or they might state that the payment is due on demand.

A bill of exchange is used in transactions pertaining to goods as well as services. It is signed by a party who owes money (called the payer) and given to a party entitled to receive money (called the payee or seller), and thus, this could be used for fulfilling the contract for payment. However, a seller could also endorse a bill of exchange and give it to someone else, thus passing such payment to some other party.

It is to be noted that when the bill of exchange is issued by the financial institutions, it's usually referred to as a bank draft. And if it is issued by an individual, it is usually referred to as a trade draft.

A bill of exchange primarily acts as a promissory note in the international trade; the exporter or seller, in the transaction addresses a bill of exchange to an importer or buyer. A third party, usually the banks, is a party to several bills of exchange acting as a guarantee for these payments. It helps in reducing any risk which is part and parcel of any transaction.

Cheques

A cheque refers to an instrument in writing which contains an unconditional order, addressed to a banker and is signed by a person who has deposited his money with the banker. This order, requires the banker to pay a certain sum of money on demand only to to the bearer of cheque (person holding the cheque) or to any other person who is specifically to be paid as per instructions given.

Cheques could be a good way of paying different kinds of bills. Although the usage of cheques is declining over the years due to online banking.

Individuals still use cheques for paying for loans, college fees, car EMIs, etc. Cheques are also a good way of keeping track of all the transactions on paper. On the other side, cheques are comparatively a slow method of payment and might take some time to be processed.

The Negotiable Instruments (Amendment) Bill, 2017

The Negotiable Instruments (Amendment) Bill, 2017 has been introduced in the Lok Sabha earlier this year on Jan 2nd, 2018. The bill seeks for amending the existing Act. The bill defines the promissory note, bill of exchange, and cheques. The bill also specifies the penalties for dishonor of cheques and various other violations related to negotiable instruments.

As per a recent circular, up to INR 10,000 along with interest at the rate of 6%-9% would have to be paid by an individual for cheques being dishonored. The Bill also inserts a provision for allowing the court to order for an interim compensation to people whose cheques have bounced due to a dishonouring party (individuals/entities at fault). Such interim compensation won’t exceed 20 percent of the total cheque value.

Meaning of Bill of Exchange

Bill of Exchange is a negotiable instrument which is a legally binding document containing an order to pay a certain sum of money to a person within a pre-determined time frame or on-demand by the bearer of the instrument.

A creditor issues Bill of Exchange to a debtor for payment of money owed by the debtor for the goods and services availed. A prominent feature of Bill of Exchange is, it needs to be accepted by a debtor to in order to be valid.

It is used in business to settle the outstanding debt between the parties involved in the transaction. There are 3 parties involved in the bill of exchange, they are:

1. Drawer: Drawer is the person who issues the instrument in order to receive a payment.
2. Drawee: Drawee is the person who needs to pay the amount to the drawer.
3. Payee: Payee is the person who receives the payment. In most cases, the drawer and the payee are the same individuals unless it is transferred to third party payee by the drawer.

Meaning of Promissory Note

A promissory note is a negotiable instrument containing written promise to pay a certain amount of money to its holder by an individual or an entity either on demand by the holder or at a pre-specified date.

The most important feature of Promissory Note is, once it is drawn by the debtor, it need not be accepted by the creditor.

Two parties are involved in the promissory note. They are:

1. Drawer/Maker: Drawer is the debtor who promises to pay the amount to lender or creditor.
2. Payee: Payee is the creditor who is been promised by the borrower or debtor about the pending payment.

Key Differences between Bill of Exchange and Promissory note represented in a comparison format are as follows

Bill of Exchange	Promissory Note
Definition	
A negotiable instrument issued to order the debtor to pay the creditor a certain sum of money within a specific date or on demand.	A negotiable instrument issued by the debtor with a written promise to pay the creditor a certain amount within a specific date or on demand.
Section	
Mentioned in Section 5 of the Negotiable Instruments Act, 1881	Mentioned in Section 4 of the Negotiable Instruments Act, 1881
Issued By	
Creditor	Debtor
Parties Involved	
Three parties involved i.e a drawer, the drawee and a payee.	Two parties involved i.e a drawer/maker and the payee

Acceptance	
Drawee needs to accept the bill of exchange before payment.	No acceptance required from the drawee.
Liability	
Liability of drawer is secondary and conditional.	Liability of drawer is primary and absolute.
Dishonouring of instrument	
Notice served to all the concerned parties involved in the transaction on dishonouring the instrument.	No notice served to the drawer in case of dishonouring the instrument.
Copies	
Bill of exchange can have copies.	The promissory note allows no copies.
Is it Payable to drawer/maker	
Yes, the same person can be drawer and payee.	The same person cannot be drawer and payee.

Ancillary Services of a Commercial Bank

Main objective of emergence of banks was to keep the people's money safe and provide loan to the people with requirement. People used to deposit their hard-earned money in banks and banks used to lend this money who are worthy to get loans (Repayment capacity). Now a days along with basic banking functions like deposit and lending facilities banks are rendering various other types of financial services to its customers. These expansion in products and services are due to various factor such as high competition among public, private and foreign banks, advancement of technology, openness to national economies for business transitions and many more. As time value of money is commonly known concept among public now a days and they know the future opportunities for their money. They don't just rely only on saving accounts investment and investing in other investment schemes. Thus, for the existence banks cannot depend on the money being deposited by the customers in the bank and had to venture in other financial services to earn profit. These banking services other than lending and deposit are known as ancillary services. Some ancillary services are as following:

- Bank draft
- Mail/ telex transfer

- Fund Transfer (NEFT/RTGS)
- Travelers cheque
- Custodial Services
- Pension
- Merchant banking
- Retail banking
- Factoring
- Bank assurance/ Guaranty
- Mutual funds
- Sale and purchase of gold
- Insurance
- Foreign exchange / Forex services
- Notary services
- Bank cards
- Venture capitalist
- Internet banking
- Mobile banking

Basel norms

- Basel norms or Basel accords are the **international banking regulations issued by the Basel Committee on Banking Supervision.**
- The Basel norms is an effort to coordinate banking regulations across the globe, with the **goal of strengthening the international banking system.**
- It is the **set of the agreement by the Basel committee of Banking Supervision** which focuses on the risks to banks and the financial system.

What is the Basel committee on Banking Supervision?

- The **Basel Committee on Banking Supervision (BCBS)** is the **primary global standard setter for the prudential regulation of banks** and provides a forum for regular cooperation on banking supervisory matters for the central banks of different countries.
- It was **established by the Central Bank governors of the Group of Ten countries in 1974.**
- The committee expanded its membership in 2009 and then again in 2014. The BCBS **now has 45 members from 28 Jurisdictions,** consisting of Central Banks and authorities with responsibility of banking regulation.
- It provides a forum for regular cooperation on banking supervisory matters.
- Its objective is to enhance understanding of key supervisory issues and **improve the quality of banking supervision worldwide.**

Why these norms?

- **Banks lend to different types of borrowers and each carries its own risk.**
- They lend the deposits of the public as well as money raised from the market i.e, equity and debt.
- This **exposes the bank to a variety of risks of default** and as a result they fall at times.
- Therefore, Banks have to keep aside a certain percentage of capital as security against the risk of non – recovery.
- The Basel committee has produced norms called Basel Norms for Banking to tackle this risk.

Why the name Basel?

- Basel is a **city in Switzerland.**
- It is the **headquarters of the Bureau of International Settlement (BIS)**, which fosters cooperation among central banks with a common goal of financial stability and common standards of banking regulations.
- It was founded in 1930.
- The **Basel Committee on Banking Supervision is housed in the BIS offices in Basel, Switzerland.**

What are these norms?

The Basel Committee has issued three sets of regulations which are known as Basel-I, II, and III.

- **Basel-I**
  - It was introduced in 1988.
  - It **focused almost entirely on credit risk.**
  - Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest.
  - It defined capital and structure of risk weights for banks.
  - The minimum capital requirement was fixed at 8% of risk weighted assets (RWA).
  - RWA means assets with different risk profiles.
  - For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral.
  - **India adopted Basel-I guidelines in 1999.**
- **Basel-II**
  - In 2004, Basel II guidelines were published by BCBS.
  - These were the refined and reformed versions of Basel I accord.
  - The guidelines were **based on three parameters, which the committee calls it as pillars.**
    - **Capital Adequacy Requirements:** Banks should maintain a minimum capital adequacy requirement of 8% of risk assets

        - **Supervisory Review:** According to this, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that a bank faces, viz. credit, market and operational risks.
        - **Market Discipline:** This needs increased disclosure requirements. Banks need to mandatorily disclose their CAR, risk exposure, etc to the central bank.
    - **Basel II norms in India and overseas are yet to be fully implemented though India follows these norms.**
- **Basel III**
    - In 2010, **Basel III** guidelines were released.
    - These guidelines were introduced in response to the financial crisis of 2008.
    - A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding.
    - It was also felt that the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk.
- The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters **viz. capital, leverage, funding and liquidity.**
    - **Capital:** The capital adequacy ratio is to be maintained at 12.9%. The minimum Tier 1 capital ratio and the minimum Tier 2 capital ratio have to be maintained at 10.5% and 2% of risk-weighted assets respectively.
        - In addition, banks have to maintain a capital conservation buffer of 2.5%. **Counter-cyclical buffer** is also to be maintained at 0-2.5%.
    - **Leverage:** The leverage rate has to be at least 3 %. The leverage rate is the ratio of a bank's tier-1 capital to average total consolidated assets.
    - **Funding and Liquidity:** Basel-III created **two liquidity ratios: LCR and NSFR.**
        - The **liquidity coverage ratio (LCR)** will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short term stress scenario as specified by supervisors.
            - This is to prevent situations like **"Bank Run".** The goal is to ensure that banks have enough liquidity for a 30-days stress scenario if it were to happen.
        - The **Net Stable Funds Rate (NSFR)** requires banks to maintain a stable funding profile in relation to their off-balance-sheet assets and activities. NSFR requires banks to fund their activities with stable sources of finance (reliable over the one-year horizon).
            - The minimum NSFR requirement is 100%. Therefore, LCR measures short-term (30 days) resilience, and NSFR measures medium-term (1 year) resilience.
- The **deadline for the implementation** of Basel-III was March 2019 in India. It was postponed to March 2020. In light of the coronavirus pandemic, the **RBI** decided to defer the **implementation of Basel norms** by further 6 months.

    - Extending more time under Basel III means lower capital burden on the banks in terms of provisioning requirements, including the NPAs.
    - This extension would impact the perception of Indian Banks and central banks in the eyes of the global players.

Bank run

It occurs when a large number of customers of a bank or other financial institution withdraw their deposits simultaneously over concerns of the bank's solvency. As more people withdraw their funds, the probability of default increases, prompting more people to withdraw their deposits.

Countercyclical capital buffer (CCCB)

- Following Basel-III norms, central banks specify certain capital adequacy norms for banks in a country. The CCCB is a part of such norms and is calculated as a fixed percentage of a **bank's risk-weighted loan book.**
    - The key respect in which the CCCB differs from other forms of capital adequacy is that it works to help a bank counteract the effect of a downturn or distressed economic conditions.
    - With the CCCB, banks are required to set aside a higher portion of their capital during good times when loans are growing rapidly, so that the capital can be released and used during bad times, when there's distress in the economy.
- Although the RBI had proposed the CCCB for Indian banks in 2015 as part of its Basel-III requirements, it hasn't actually required the CCCB to be maintained, keeping the ratio at zero percent ever since.
- This is based on the RBI's review of the credit-GDP gap, the growth in GNPA, the industry outlook assessment index, interest coverage ratio and other indicators, as part of the first monetary policy of every financial year.

Tier 1 Capital vs. Tier 2 Capital

- Banks have **two main silos** of capital that are qualitatively different from one another.
    - **Tier 1:** It refers to a bank's core capital, equity, and the disclosed reserves that appear on the bank's financial statements.
        - In the event that a bank experiences significant losses, Tier 1 capital provides a cushion that allows it to weather stress and maintain a continuity of operations.
    - **Tier 2:** It refers to a bank's supplementary capital, such as undisclosed reserves and unsecured subordinated debt instruments that must have an original maturity of at least five years.
- Tier 2 capital is considered less reliable than Tier 1 capital because it is more difficult to accurately calculate and more difficult to liquidate.