**Indian Banking System**

**UNIT -1**

**Topic covered :-**Introduction of banking, Structure and growth, Development of Banking in India, Reforms of Banking sector, source of banking income, Role of banking system in the economic growth and development, importance of banking system for financial inclusion.

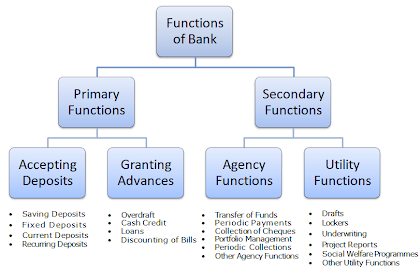
## Introduction: - The term bank is either derived from old Italian word *banca* or from a French word *banque* both mean a Bench or money exchange table. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging. A bank is a financial institution which deals with deposits and advances and other related services. It receives money from those who want to save in the form of deposits and it lends money to those who need it.

## Definition: - A bank as "an establishment for custody of money, which it pays out on customer's order."

**Characteristics / Features of a Bank**

1. **Dealing in Money:-**Bank is a financial institution which deals with other people's money i.e. money given by depositors.
2. **Individual / Firm / Company:-**A bank may be a person, firm or a company. A banking company means a company which is in the business of banking.
3. **Acceptance of Deposit:-**A bank accepts money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. It gives safety to the deposits of its customers. It also acts as a custodian of funds of its customers.
4. **Giving Advances:-**A bank lends out money in the form of loans to those who require it for different purposes.
5. **Payment and Withdrawal:-**A bank provides easy payment and withdrawal facility to its customers in the form of cheques and drafts, It also brings bank money in circulation. This money is in the form of cheques, drafts, etc.
6. **Agency and Utility Services:-**A bank provides various banking facilities to its customers. They include general utility services and agency services.
7. **Profit and Service Orientation:-** A bank is a profit seeking institution having service oriented approach.
8. **Ever increasing Functions:-** Banking is an evolutionary concept. There is continuous expansion and diversification as regards the functions, services and activities of a bank.
9. **Connecting Link:-** A bank acts as a connecting link between borrowers and lenders of money. Banks collect money from those who have surplus money and give the same to those who are in need of money.
10. **Banking Business:-** A bank's main activity should be to do business of banking which should not be subsidiary to any other business.
11. **Name Identity:-**A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.

**Function of Bank**

****

1. **Primary Functions of Banks:-** The primary functions of a bank are also known as banking functions. They are the main functions of a bank.These primary functions of banks are explained below.
2. **Accepting Deposits:-** The bank collects deposits from the public. These deposits can be of different types, such as:-

* Saving Deposits
* Fixed Deposits
* Current Deposits
* Recurring Deposits

1. **Saving Deposits: -** This type of deposits encourages saving habit among the public. The rate of interest is low. At present it is about 4% p.a. Withdrawals of deposits are allowed subject to certain restrictions. This account is suitable to salary and wage earners. This account can be opened in single name or in joint names.
2. **Fixed Deposits: -** Lump sum amount is deposited at one time for a specific period. Higher rate of interest is paid, which varies with the period of deposit. Withdrawals are not allowed before the expiry of the period. Those who have surplus funds go for fixed deposit.
3. **Current Deposits: -** This type of account is operated by businessmen. Withdrawals are freely allowed. No interest is paid. In fact, there are service charges. The account holders can get the benefit of overdraft facility.
4. **Recurring Deposits:-**This type of account is operated by salaried persons and petty traders. A certain sum of money is periodically deposited into the bank. Withdrawals are permitted only after the expiry of certain period. A higher rate of interest is paid.
5. **Granting of Loans and Advances:-**The bank advances loans to the business community and other members of the public. The rate charged is higher than what it pays on deposits. The difference in the interest rates (lending rate and the deposit rate) is its profit. The types of bank loans and advances are :-

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

1. **Overdraft: -** these types of advances are given to current account holders. No separate account is maintained. All entries are made in the current account. A certain amount is sanctioned as overdrafts which can be withdrawn within a certain period of time say three months or so. Interest is charged on actual amount withdrawn. An overdraft facility is granted against a collateral security. It is sanctioned to businessman and firms.
2. **Cash Credits: -** The client is allowed cash credit up to a specific limit fixed in advance. It can be given to current account holders as well as to others who do not have an account with bank. Separate cash credit account is maintained. Interest is charged on the amount withdrawn in excess of limit. The cash credit is given against the security of tangible assets and / or guarantees. The advance is given for a longer period and a larger amount of loan is sanctioned than that of overdraft.
3. **Loans:-**It is normally for short term say a period of one year or medium term say a period of five years. Now-a-days, banks do lend money for long term. Repayment of money can be in the form of installments spread over a period of time or in a lump sum amount. Interest is charged on the actual amount sanctioned, whether withdrawn or not. The rate of interest may be slightly lower than what is charged on overdrafts and cash credits. Loans are normally secured against tangible assets of the company.
4. **Discounting of Bill of Exchange:-** The bank can advance money by discounting or by purchasing bills of exchange both domestic and foreign bills. The bank pays the bill amount to the drawer or the beneficiary of the bill by deducting usual discount charges. On maturity, the bill is presented to the drawee or acceptor of the bill and the amount is collected.
5. **Secondary Functions of Banks:-**The bank performs a number of secondary functions, also called as non-banking functions. These important secondary functions of banks are explained below.
6. **Agency Functions:-**The bank acts as an agent of its customers. The bank performs a number of agency functions which includes:-

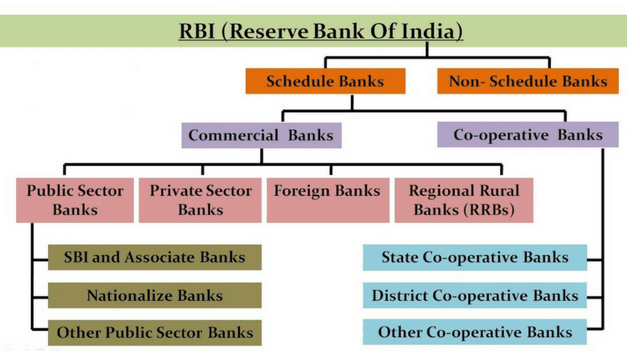
* Transfer of Funds
* Collection of Cheques
* Periodic Payments
* Portfolio Management
* Periodic Collections
* Other Agency Functions

1. **Transfer of Funds:-**The bank transfer funds from one branch to another or from one place to another.
2. **Collection of Cheques:-**The bank collects the money of the cheques through clearing section of its customers. The bank also collects money of the bills of exchange.
3. **Periodic Payments: -** On standing instructions of the client, the bank makes periodic payments in respect of electricity bills, rent, etc.
4. **Portfolio Management:-**The bank also undertakes to purchase and sell the shares and debentures on behalf of the clients and accordingly debits or credits the account. This facility is called portfolio management.
5. **Periodic Collections:-** The bank collects salary, pension, dividend and such other periodic collections on behalf of the client.
6. **Other Agency Functions: -** They act as trustees, executors, advisers and administrators on behalf of its clients. They act as representatives of clients to deal with other banks and institutions.
7. **General Utility Functions:-** The bank also performs general utility functions, such as :-

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

1. **Issue of Drafts and Letter of Credits:-** Banks issue drafts for transferring money from one place to another. It also issues letter of credit, especially in case of, import trade. It also issues travelers’ cheques.
2. **Locker Facility: -** The bank provides a locker facility for the safe custody of valuable documents, gold ornaments and other valuables.
3. **Underwriting of Shares: -** The bank underwrites shares and debentures through its merchant banking division.
4. **Dealing in Foreign Exchange:**- The commercial banks are allowed by RBI to deal in foreign exchange.
5. **Project Reports:**-The bank may also undertake to prepare project reports on behalf of its clients.
6. **Social Welfare Programmes:**-It undertakes social welfare programmes, such as adult literacy programmes, public welfare campaigns, etc.
7. **Other Utility Functions:**-It acts as a referee to financial standing of customers. It collects creditworthiness information about clients of its customers. It provides market information to its customers, etc. It provides travelers’ cheque facility.

**Structure of Indian Banking System**

****

**Organizational Structure**

1. **Reserve Bank of India:** - Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 accordance with the provisions of the Reserve Bank of India Act, 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions.

It has given wide powers to supervise and control the banking structure. It occupies the pivotal position in the monetary and banking structure of the country. In many countries central bank is known by different names.

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

These institutions run to make profit. They cater to the financial requirements of industries and various sectors like agriculture, rural development, etc. it is a profit making institution owned by government or private of both.

1. **Public Sector Banks: -** Currently there are 21 nationalized banks in India. The public sector accounts for 75 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks.

Now from April 1, 2017 all the 5 associate banks of SBI and Bhartiya Mahila Bank are merged with State Bank of India. After this merger now SBI is counted among the top 50 largest banks of the world.

1. **Private Sector Banks: -** The **private-sector banks in India** represent part of the **Indian banking sector** that is made up of both **private** and public **sector banks**. The **"private-sector banks"** are **banks** where greater parts of stake or equity are held by the **private** shareholders and not by government.
2. **Foreign Banks:** - A foreign bank with the obligation of following the regulations of both its home and its host countries. Loan limits for these banks are based on the capital of the parent bank, thus allowing foreign banks to provide more loans than other subsidiary banks.

Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India. Currently India has 36 foreign banks.

1. **Regional Rural Bank (RRB):-** The government of India set up Regional Rural Banks (RRBs) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural laborers, and small entrepreneurs. There are 82 RRBs in the country. NABARD holds the apex position in the agricultural and rural development.
2. **Co-operative Bank: -** Co-operative bank was set up by passing a co-operative act in 1904. They are organized and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.

The cooperative banks in India play an important role even today in rural co-operative financing. The enactment of Co-operative Credit Societies Act, 1904, however, gave the real impetus to the movement. The Cooperative Credit Societies Act, 1904 was amended in 1912, with a view to broad basing it to enable organization of non-credit societies.

**Name of some co-operative banks India are:**

**1.** Andhra Pradesh State Co-operative Bank Ltd

**2.** The Bihar State Co- operative Bank Ltd.

**3.** Chhatisgarh Rajya Sahakari Bank Maryadit

**4.** The Gujarat State Co-operative Bank Ltd.

**5.** Haryana Rajya Sahakari Bank Ltd.

**Scheduled and Non-Scheduled Banks:**

The scheduled banks are those which are enshrined in the second schedule of the RBI Act, 1934. These banks have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs; they have to satisfy the RBI that their affairs are carried out in the interest of their depositors.

All commercial banks (Indian and foreign), regional rural banks, and state cooperative banks are scheduled banks. Non- scheduled banks are those which are not included in the second schedule of the RBI Act, 1934. At present these are only three such banks in the country.

**History/ Growth of Indian Banking System**

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865, was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with head quarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935.

At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government’s ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks were opened.

### DEVELOPMENT BANKS IN INDIA

**A Development Bank** is a polygonal development finance institution devoted to improving the social and monetary development of its associate nations. It helps improve the value of people's lives by providing loans and scientific support for a broad variety of development activities.

## Objectives of Development Banks

The main objectives of the development banks are

1. To promote industrial growth,

2. To develop backward areas,

3. To create more employment opportunities,

4. To generate more exports and encourage import substitution,

5. To encourage modernization and improvement in technology,

6. To promote more self employment projects,

7. To revive sick units,

8. To improve the management of large industries by providing training,

9. To remove regional disparities or regional imbalance.

## Development Banks in India

Working capital requirements are provided by commercial banks, indigenous bankers, co-operative banks, money lenders, etc. The money market provides short-term funds which mean working capital requirements.

The long term requirements of business concerns are provided by industrial banks, and the various long term lending institutions which are created by government. In India these long term lending institutions are collectively referred as development banks. They are:

1. Industrial Finance Corporation of India (IFCI), 1948
2. Industrial Credit and Investment Corporation of India (ICICI), 1955
3. Industrial Development of Bank of India (IDBI), 1964
4. Small Industries Development Bank of India (SIDBI), 1990
5. Export Import Bank (EXIM)
6. National Bank for Agriculture and Rural Development (NABARD).
   1. **IFCI**: - The IFCI was the first specialized financial institution set up in India to provide term finance to large industries in India. It was established on 1st July, 1948 under the Industrial Finance Corporation Act of 1948.

**Objectives of IFCI**

The main objective of IFCI is to provide medium and long term financial assistance to large scale industrial undertakings, particularly when ordinary bank accommodation does not suit the undertaking or finance cannot be profitably raised by it from the issue of shares.

**Functions of IFCI**

* For setting up a new industrial undertaking.
* For expansion and diversification of existing industrial undertaking.
* For renovation and modernization of existing concerns.
* For meeting the working capital requirements of industrial concerns in some exceptional cases.
  1. **ICICI**:-ICICI is an Indian diversified financial services company headquartered in Mumbai, Maharashtra. The Bank has a network of 2,630 branches and 8,003 ATM's in India, and has a presence in 19 countries, including India.

### OBJECTIVES OF ICICI

### Assisting in the creation

### Expansion

### Modernization of such enterprises

### Encouraging and promoting the participation private capital

### Encouraging and promoting private ownership

### FUNCTIONS OF ICICI

* Assistance to industries
* Provision of foreign currency loans
* Merchant banking
* Letter of credit
* Project promotion
* Housing loans
* Leasing operations
  1. **Industrial Development Bank of India (IDBI):-** Industrial development Bank of India (IDBI) came into being on 1st July, as a Development Institutions under IDBI Act 1964. It is headquartered at Mumbai. It is regarded as a Public Financial Institution in terms of Companies Act. It continued as DPI till 2004 when it was transferred into a Bank. To transform this into Bank/ Industrial Development Bank Act 2003 was passed. A new company under the name of Industrial Development Bank of India Ltd. was incorporated as a Govt company under the Companies Act on 27th September, 2004, and thus now it came to be known as IDBI Ltd. On 1st October 2004 but it also worked as a Bank in terms of the Repeal Act. With effect from 2nd April, 2005, IDBI Bank Ltd was finally amalgamated with IDBI Ltd and was known as IDBI Ltd. It is a Public Sector Bank as government has above 70% shareholding in this Bank.
  2. **SIDBI: -** Small Industries Development Bank of India (SIDBI) was set up under an Act of Parliament in 1990. Though it was a wholly owned subsidiary of Industrial Development Bank of India, presently the ownership is held by 33 Government of India owned / controlled institutions. It is headquartered in Lucknow.

**Functions:**

* To initiate steps for technological up gradation and modernization of existing units.
* To expand the channels for marketing the products of SSI sector in domestic and international markets.
* To promote employment oriented industries especially in semi-urban areas to create more employment opportunities and thereby checking migration of people to urban areas.
  1. **Export-Import Development Bank:** - The Export-Import Bank of India (Exim Bank) is a public sector financial institution created by an Act of Parliament, the Export-import Bank of India Act, 1981. The business of Exim Bank is to finance Indian exports that lead to continuity of foreign exchange for India. The Exim Bank extends term loans for foreign trade.
  2. **Agricultural Development Bank:-** It includes, for example. National Bank for Agriculture & Rural Development (NABARD). National Bank for Agriculture and Rural Development (NABARD) is an apex development bank in India having headquarters based in Mumbai (Maharashtra) and other branches are all over the country. It was established on 12 July 1982 by a special act by the parliament and its main focus was to uplift rural India by increasing the credit flow for elevation of agriculture & rural non-farm sector. NABARD is the apex institution in the country which looks after the development of the cottage industry, small industry and village industry, and other rural industries.

**Role:**

* Undertakes monitoring and evaluation of projects refinanced by it.
* Refinances the financial institutions which finance the rural sector.
* Regulates the institutions which provide financial help to the rural economy.
* Provides training facilities to the institutions working in the field of rural upliftment.
* Regulates the cooperative banks and the RRBs.

**Banking sector Reforms**

Since 1991, the Indian financial system has undergone radical transformation. Reforms have altered the organizational structure, ownership pattern and domain of operations of banks, ﬁnancial institutions and Non-banking Financial Companies (NBFCs). The main thrust of reforms in the ﬁnancial sector was the creation of efficient and stable ﬁnancial institutions and markets.  Reforms in the banking and non-banking sectors focused on creating a deregulated environment, strengthening ensuring the prudential norms and the supervisory system, changing the ownership pattern and increasing competition.

**Narasimham Committee Report on Banking Sector Reforms**

The United Front Government appointed Narasimham committee to review the progress of reforms in the banking sector. The committee submitted its report to the then Finance Minister on April 23, 1998. The main objective of the Banking Sector Reforms Committee was to establish a strong, efficient and proﬁtable banking system of the global standard.

**NARASIMHAM COMMITTEE REPORT ON BANKING SECTOR REFORMS**

**1) Strengthening the Banking System:-**

(i) Capital adequacy requirements should take into consideration market risks in addition to credit risks.

(ii) Risk weight of a government guaranteed advance should be the same as other advances.

(iii) Minimum capital to risk assets ratio (CRAR) be increased from the existing 8 per cent to 10 per cent. There should be penal provisions for bank that do not maintain CRAR.

**2) Asset Quality:-**

The following recommendations have been made to improve asset quality:

1. The ratio of non-performing assets to the total assets should be reduced.

(ii)For evaluating the quality of assets portfolio, advanced covered by Government guarantees, which have turned stick, be treated as Non- performing Assets.

(iii) For banks with a high NPA portfolio, the following two alternative approaches could be adopted.

**3) Systems and Methods in Banks:-**

The committee made the following recommendations to improve the systems and methods in banks:

(i) There should be an independent loan review mechanism specially for large borrowed accounts and systems to identify potential Non-performing Assets (NPA).

(ii) Banks and financial institutions should have a system of recruiting skilled manpower from the open market.

(iii) Public sector banks should be given flexibility to determine managerial remuneration  levels taking into account market trends.

**4) Structural Issues:-**

The following recommendations have been made regarding structural issues of the banks:

(i) With the convergence of activities between banks and Developmental Financial Institution DFI , the later should over a period of time convert themselves to bank.

(ii) Banking system should be reconstituted:

(a) 2 or 3 banks with an international evaluation should be established.

(b) 8 or IO large banks should be established. These banks should take care of the needs of  the large and medium corporate sectors and the larger of the small enterprises.

(c) There should be a large number of local banks

**5) Technological Up gradation:-** There should be rapid computerization of the banking. There should be modernization and technology up gradation of the banking operations.

**Banking Sector Reform Measures**

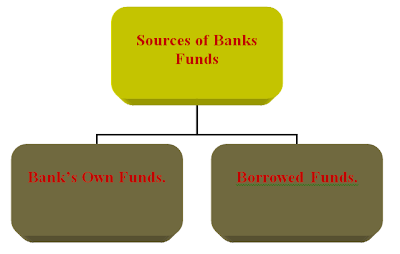
* **Deregulation of Interest Rates**: In order to provide operational flexibility and competitive environment to the banks, interest rates on deposits and loan advances of all commercial banks  including urban co-operative banks have been deregulated, Le. , controls and regulations of the RBI on interest rate have been abolished. Interest rate is allowed to be determined independently by the banks.
* **Reduction in Reserve Requirements**: As per the recommendations of the Narasimham Committee, reserve requirements of the commercial bank have been drastically reduced in order to ease the availability of liquidity for credit and to enhance the role of the market forces. High reservation implies high cost of credit and less availability of bonds for borrowing.
* **Measures to Improve Competitive Efficiency in Banking Sector**: For improving the competitive efficiency of the banking sector, all nationalized commercial banks are allowed to raise capital from equity market. Operational autonomy was given to the banks. Private sector, foreign banks and insurance companies were also allowed to enter into the banking sector.
* **Prudential Norms**: Narasimham committee recommended for introduction of prudential  norms o measure the performance of the banking sector. Accordingly, income recognition, assets classiﬁcation, provision for bad debts, norms on connected lending, risk concentration, etc., were  introduced. As per the RBI directives, all the commercial banks are adopted uniform and sound
* **Transparency Measures**: For transparency in banking operation, banks are required to disclose their balance sheet with detailed information as per the norms specified by the International Accounts Standard Committee.
* **Capital Adequacy Measures**: M. Narasimham Committee recommended for setting up some new and higher norms for capital adequacy, 2'.e., capital to risk weighted assets ratio. It was recommended that capital adequacy ratio should at least be 8 per cent. All the public sector banks were required to attain this norm by 1996.

**Recent Measures towards Reforming Banking Sector**

According to the Report on “Trend and Progress of Banking in India" (2002), the following reforms or major policy developments have been introduced in the banking sector:

* The RBI has liberalized the norms for issue and pricing of shares by private sector banks.  According to the revised norms, all private sector banks would be free to issue bonus and rights issues without prior approval of the RBI. Moreover, bonus issue will now be delinked from the rights issue.
* The banks can issue smart cards (both online and offline) to select customers with good ﬁnancial standing subject to their ensuring the implementation of know your customer’ concept.
* All scheduled commercial banks, excluding Regional Rural Banks (RRBs) have been advised to maintain with RBI a CRR of5 per cent of Net Demand and Time Liabilities (NDTL) with  effect from June 1, 2002.

### Sources of Bank Funds



**Brief Introduction about Bank:** A **bank** is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly or through capital markets. A bank connects customers with capital deficits to customers with capital surpluses

**Sources of Banks Funds:** A bank is a business firm. Its main aim is to earn profit. In order to achieve this objective it provides services to the customers. It offers a variety of interest bearing obligations to the public. These obligations are the sources of funds for the bank and are shown on the liability side of the balance sheet of a commercial bank. The main sources which supply funds to a bank are as follows:

* Bank’s Own Funds.
* Borrowed Funds.

1. **Bank’s own funds.** Bank’s own funds are mainly of three types;
2. **Paid up capital:-**Bank’s own paid up capital. The amount with which a banking company is registered is called nominal or authorized capital. It is the maximum amount of capital which is mentioned in the capital clause of the memorandum of association of the company. Capital is further divided into (i) paid up capital and (ii) subscribed capital.
3. **Reserve fund.-**Reserve is another source of fund which is maintained by all commercial banks. At the time of declaring dividend, a certain portion of the profit is transferred to the reserve fund. This reserve belongs to the .shareholders and at the time of liquidation, the Shareholders are entitled to these reserves along with the capital. The main purpose of setting aside part of profit is to meet unforeseen expenses of the bank.
4. **Profit. -** Profit is another source to a bank for the purpose of business. Profits signify the credit balance of the profit and loss account which has not been distributed. The accumulated profits over the years increase the working capital of the bank and strengthen its financial position.
5. **Borrowed Funds. -** The borrowed capital is a major and an important source of fund for any banking business. It mainly comes from deposits which are accepted on varying terms in different accounts. Bank’s borrowing is mostly in the form of deposits. Bank collects three kinds of deposits from its customers (1) current or demand deposits (2) saving deposits and (3) fixed or time deposits. The larger the deposits of bank, the larger will be its (use) fund for employment and so higher are its profit.
6. **Borrowing from central bank.**  - The commercial banks in times of emergency borrow loans from the central bank of the country. The central bank extends help as and when financial help is required by the commercial banks.
7. **Other sources.** - Bank also raise funds by issuing bonds, debentures, cash certificates etc. etc. Though it is not common but is a dependable source of borrowing.
8. **Bond**s: - A bond is a debt security, in which the authorized issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest (the coupon) to use and/or to repay the principal at a later date, termed maturity. A bond is a formal contract to repay borrowed money with interest at fixed intervals
9. **Debenture:-**A type of debt instrument that is not secured by physical asset or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond in order to secure capital. Like other types of bonds, debentures are documented in an indenture.
10. **Cash certificates:-** Cash certificates and recurring deposits are similar types of banking investments. The terms are used most often in relation to the services that Indian banks provide their customers. These deposits are not directly related to stock market or bond speculation, but instead give investors a way to earn interest on money in a safer setting.
11. **Deposits.** Public deposits are a powerful source of funds to a bank. There are’ three types of bank deposits (i) current deposits (ii) saving deposits and (iii) time deposits. Due to the spread of literacy, banking habits and growth in the volume of business operations, there is a marked increase in deposit money with banks.
    * 1. **Current Deposit:** - In deposit terminology, the term Current Deposit refers to a deposit to a bank account or financial institution without a specified maturity date. These types of Current Deposit account generally only earn demand deposit interest. Interest is very low for current account.
      2. **Saving deposits:** - A deposit account held at a bank or other financial institution that provides principal security and a modest interest rate. Depending on the specific type of savings account, the account holder may not be able to write checks from the account (without incurring extra fees or expenses) and the account is likely to have a limited number of free transfers/transactions. Savings account funds are considered one of the most liquid investments outside of demand accounts and cash. In contrast to savings accounts, checking accounts allow you to write checks and use electronic debit to access your funds inside the account. Savings accounts are generally for money that you don't intend to use for daily expenses
      3. **Time Deposit: -** A time deposit also known as a term deposit is a money deposit at a banking institution that cannot be withdrawn for a certain "term" or period of time (unless a penalty is paid). When the term is over it can be withdrawn or it can be held for another term. Generally speaking, the longer the term the better the yield on the money. A certificate of deposit is a time-deposit product

**Factors determine the cost of sourcing of bank funds:**

* 1. **Cost of funds: -** Cost of funds are the expenses incurred on obtaining funds from various sources in the form of share capital, reserves, deposits, and borrowings.
  2. **Cost Interest Rate Risk:** The risk of loss due to a change in interest rates. Interest rate risk is important to transactions like interest rate swaps. In such a transaction, the party receiving the floating rate will receive a smaller amount should the floating rate decrease. Interest rate risk is also important to bonds; if interest rates rise, the prices of bonds fall. This affects the secondary market for bonds; for example, if one purchases a bond with a 3% interest rate and the prevailing rate rises to 5%, it becomes difficult or impossible to resell the bond at a profit. Finally, interest rate risk is important also a factor which influenced the cost of sourcing of bank funds.
  3. **Yield on funds;** The funds raised by the bank through various sources are deployed in various assets. These assets yield income in the form of interest. So, higher the interest, greater the profitability and if yield of fund is good then cost of fund will low.
  4. **Spread:** Spread is defined as the difference between the interest received (interest income ) and the interest paid (interest expense ) in funding. Higher spread indicates more efficient financial intermediation and higher net income so if the interest income is more then cost of capital will low and banks always sources fund for gaing certain profit. Thus, higher spread leads to higher profitability and decrease the cost of fund.
  5. **Level of technology:** Use of upgraded technology normally leads to decline in the operating costs of banks and it also affects the cost of funding. This improves the profitability of banks
  6. **Nature of Deposits:** Deposits trade with the banks are of various types like time deposits, demand deposits, short – term deposits, etc. larger demand deposits /short – term deposits also influenced the cost of funding.

**Sources of income for a bank**

* 1. **Interest on loans:** Banks provide various loans and advances to industries, corporate and individuals. The interest received on these loans is their main source of income.
  2. **Interest on investments:** Banks invest in various governments and rated securities, and earn interest and dividends from these investments.
  3. **Fees income:** Banks charge fees for performing services like syndication of loans, accepting bills of exchange, providing safety vaults, etc. for their customers.
  4. **Forex operations:** Banks also deal in foreign exchange and act as brokers for the same, earning an income from these operations.
  5. **Commission on third party products:** Banks earn commission income by distributing insurance and mutual fund products to their customer base.

**Role of Banks in economic development**

Banks play a very useful and crucial role in the economic life of every nation. They have control over a large part of the supply of money in circulation, and they can influence the nature and character of production in any country.

**1) Removing the deficiency of capital formation**:- In any economy, economic development is not possible unless there is an adequate degree of capital accumulation (or) formation. Deficiency of capital formation is the result of low saving made by the community. The serious capital deficiency in developing economies is reflected in small amount of capital equipment per worker and the limited knowledge, training and scientific advance. At this juncture, banks play a useful role. Banks stimulate saving and investment to remove this deficiency. A sound banking system mobilizes small savings of the community and makes them available for investment in productive enterprises. The important implications of this activity include Banks mobilise deposits by offering attractive rates of interest and thus convert savings into active capital. Otherwise that amount would have remained idle.

Banks distribute these savings through loans among productive enterprises which are helpful in nation building.

 It facilitates the optimum utilization of the financial resources of the community.

**2) Provision of finance and credit**:- Banks are very important sources of finance and credit for industry and trade. It is observed that credit is the lubricant of all commerce and trade. Hence, banks become nerve centers of all trade activities and therefore commerce and trade could function in the presence of sound banking system.

The banks cover foreign trade transactions also. Big banks also undertake foreign exchange business. They help in concluding deferred payments, arrangements between the domestic industrial undertakings and foreign firms to enable the former import machinery and other essential equipment.

**3) Extension of the size of the market:-** Commercial bankers help commerce and industry in yet another way. With the sound banking system, it is possible for commerce and industry for extending their field of operation. Commercial banks act as an intermediary between buyers and the sellers. Goods are supplied on bank guarantees, making it viable for industry and commerce to cultivate and locate markets for their products. The risks are undertaken by the bank. When the risks have been set free by the banks, the industry can look forward to derive economies of the large size of the market.

**4) Act as an engine of balanced regional development**:-Commercial banks help in proper allocation of funds among different regions of the economy. The banks operate primarily for profits. When the banks lend their funds for more productive uses, their profits will be maximized. Introduction of branch banking makes it possible to choose between different regions. A region with growth potential attracts more bank funds. But in recent years, the approach of banks towards regional growth has been undergoing a change. Banks help create infrastructure essential for economic development. Thus banks are engines of balanced regional development in the country.

**5) Financing agriculture and allied activities**:- The commercial bank helps the farmers in extending credit for agricultural development. Farmers require credit for various purposes like making their produce, for the modernization and mechanization of their agriculture, for providing irrigation facilities and for developing land.

The banks also extend their financial assistance in the areas of animal husbanding, dairy farming, sheep breeding, poultry farming and horticulture.

**6) For improving the standard of living of the people**:- The standard of living of the people is estimated on the basis of the consumption pattern. The banks advance loans to consumers for the purchase of consumer durables and other immovable property, which will raise the standard of living of the people.

 Stimulating human capital formation, facilitating monetary policy formulation and developing entrepreneurs are some of the other roles played by commercial banks in the economic life of every nation.

**Financial Inclusion**

It is the pursuit of delivering financial services, including payments, savings, credit, etc., to people of low-income and disadvantaged sections of the society at affordable costs. It is also called ‘**Inclusive Financing’**. **Financial Inclusion**’s main **objective**is to address constrains that exclude people from participating in the financial sector & make financial services available to them to meet their specific needs without any kind of discrimination.

## Objectives of Financial Inclusion

* Financial inclusion intends to help people secure financial services and products at economical prices such as deposits, fund transfer services, loans, insurance, payment services, etc.
* It aims to establish proper financial institutions to cater to the needs of the poor people. These institutions should have clear-cut regulations and should maintain high standards that are existent in the financial industry.
* Financial inclusion aims to build and maintain financial sustainability so that the less fortunate people have a certainty of funds which they struggle to have.
* Financial inclusion also intends to have numerous institutions that offer affordable financial assistance so that there is sufficient competition so that clients have a lot of options to choose from. There are traditional banking options in the market. However, the number of institutions that offer inexpensive financial products and services is very minimal.
* Financial inclusion intends to increase awareness about the benefits of financial services among the economically underprivileged sections of the society.
* The process of financial inclusion works towards creating financial products that are suitable for the less fortunate people of the society.
* Financial inclusion intends to improve financial literacy and financial awareness in the nation.
* Financial inclusion aims to bring in digital financial solutions for the economically underprivileged people of the nation.
* It also intends to bring in mobile banking or financial services in order to reach the poorest people living in extremely remote areas of the country.
* It aims to provide tailor-made and custom-made financial solutions to poor people as per their individual financial conditions, household needs, preferences, and income levels.
* There are many governmental agencies and non-governmental organisations that are dedicated to bringing in financial inclusion. These agencies are focussed on improving the access to receiving government-approved documents. Many poor people are unable to open bank accounts or apply for a loan as they do not have any identity proof. There are so many people who live in rural areas or tribal villages who do not have knowledge about documents such as PAN, Aadhaar, Driver’s License, or Electoral ID. Hence, they cannot avail many of the services offered by governmental or private institutions. Due to lack of these documents, they are unable to avail any form of subsidies offered by the government that they are actually entitled to.

## Need for Financial Inclusion

Financial inclusion enhances the financial system of the country comprehensively. It strengthens the availability of economic resources. Most importantly, it toughens the concept of savings among poor people living in both urban and rural areas. This way, it contributes towards the progress of the economy in a consistent manner.

Many poor people tend to get cheated and sometimes even exploited by rich landlords as well as unlicensed moneylenders due to the vulnerable condition of the poor people. With the help of financial inclusion, this serious and hazardous situation can be changed.

Financial inclusion engages in including poor people in the formal banking industry with the intention of securing their minimal finances for future purposes. There are many households with people who are farmers or artisans who do not have proper facilities to save the money that they earn after putting in so much effort.

**Importance of Financial Inclusion in India**

Despite India boasting economic growth rates higher than most developed countries in recent years, a majority of the country’s population still remains unbanked. Financial Inclusion is a relatively new socio-economic concept in India that aims to change this dynamic by providing financial services at affordable costs to the underprivileged, who might not otherwise be aware of or able to afford these services. Global trends have shown that in order to achieve inclusive development and growth, the expansion of financial services to all sections of society is of utmost importance. As a whole, financial inclusion in the rural as well as financially backward pockets of cities is a win-win opportunity for everybody involved – the banks/NBFC’s intermediaries, and the left-out urban population. Banks will handle core infrastructure and services while intermediaries known as Business Correspondents (BC’s) will be the executors and act as the face of these banking & financial institutions in dealing with end-users. The Business Correspondents (BC’s) shall be carrying handheld terminals like Tablets (GSM enabled) coupled with portable biometric scanner, smart card swipe machines as well as thermal Bluetooth printers for carrying out their online banking activities on the field. Authentication and customer information is provided by the UIDA through NPCI or NSDL once the institution becomes an authorized UIDAI user. As income levels and consequently, savings in rural areas increase, it is essential to help earners manage their funds and facilitate incoming and outgoing payments. Allowing people to create simple, no-frills current and savings accounts, relaxing KYC norms and directly crediting social benefits to account owners will bolster an inclusive approach to finance & banking in rural areas.

### Reasons Financial Inclusion in India is Important:

Financial inclusion of the unbanked masses is a critical step that requires political will, bureaucratic support and constant pressure by the RBI. It is expected to unleash the hugely untapped potential of the bottom-of-pyramid section of Indian economy.

**Benefits of financial inclusion**:

* The rural masses will get access to banking like cash receipts, cash payments, balance enquiry and statement of account can be completed using fingerprint authentication. The confidence of fulfillment is provided by issuing an online receipt to the customer.
* Reduction in cash economy as more money is brought into the banking ecosystem
* It inculcates the habit to save, thus increasing capital formation in the country and giving it an economic boost.
* Direct cash transfers to beneficiary bank accounts, instead of physical cash payments against subsidies will become possible. This also ensures that the funds actually reach the intended recipients instead of being siphoned off along the way.
* Availability of adequate and transparent credit from formal banking channels will foster the entrepreneurial spirit of the masses to increase output and prosperity in the countryside.

**UNIT- 2**

**Topic covered: -** Evolution of the Reserve Bank of India, Organization and management of the RBI, function of the RBI; NABARD- its function and organization: Schedule commercial Banks, Regional Rural Bank, Cooperative Banking, Private Banking and foreign Banking ; An overview of Non-Banking financial companies/Institutions.

**RBI (Reserve Bank of India)**

The **Reserve Bank of India** (**RBI**) is India’s central bank and controls the monetary policy of the Indian rupee. It commenced its operations on 1 April 1935. The RBI was nationalized on 1 January, 1949. A central bank is a vital financial apex institution of an economy and the key objects of central banks may differ from country to country still they perform activities and functions with the goal of maintaining economic stability and growth of an economy.

## Evolution of RBI

* 1926: The Royal Commission on Indian Currency and Finance recommended the creation of a central bank for India.
* 1927: A bill to give effect to the above recommendation was introduced in the Legislative Assembly. But it was later withdrawn due to lack of agreement among various sections of people.
* 1933: The White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
* 1934: The Bill was passed and received the Governor General’s assent
* 1935: The Reserve Bank commenced operations as India’s central bank on April 1 as a private shareholders’ bank with a paid up capital of rupees five crores (rupees fifty million).
* 1942: The Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
* 1947: The Reserve Bank stopped acting as banker to the Government of Burma.
* 1948: The Reserve Bank stopped rendering central banking services to Pakistan.
* 1949: The Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
* Currently, the Bank’s Central Office, located at Mumbai, has twenty-seven departments. These departments frame policies in their respective work areas. They are headed by senior officers in the rank of Chief General Manager.

## Organization

The Reserve Bank of India was originally established as a shareholders’ bank with a share capital of Rs.5 crores, divided into 5 lakhs fully paid-up shares of Rs.100 each. When the bank was nationalized in 1949, the entire share capital was acquired by the Central Government by compensating the shareholders.

## Management

The general superintendence and direction of the affairs of the Reserve Bank of India are vested in the Central Board of Directors, which consists of 20 members as detailed below:

1. A Governor and Four Deputy Governors appointed by the Central Government,
2. Four Directors nominated by the Central Government,
3. Ten other Directors, and
4. One Government official nominated by the Central Government.

**Organizational structure**

Governor of the Reserve Bank of India acts as the Chairman of the Central Board of Directors of the Bank and its chief executive authority. The Governor can exercise all the powers, which can be exercised by the Bank under the Act. However, his powers subject to the regulations made by the Central Board of Directors from time to time. In the performance of his duties, the Deputy Governors and the Executive Directors assist him. Each Deputy Governor is responsible for certain specific operations of the Bank. The Governor and the Deputy Governors are appointed by the Central Government for a period not exceeding 5 years. They are eligible for reappointment. They are full-time officers of the Bank.

The 10 directors who are nominated by the Central Government hold office for a period of 4 years. The Act provides for their retirement by rotation and every year two directors shall retire. However, the retiring director is eligible for re-election.

There are Local Boards for four regions of the country such as Western, Eastern, Northern and Southern regions. The head quarters of the Local Hoards are situated at Mumbai, Kolkata, Chennai and New Delhi. Each Local Board consists of five members. All the members are appointed by the Central Government. The members should represent, as far as possible, territorial and economic interests and the interests of cooperative and indigenous banks.

The members of the Local Board are appointed for a period of four years. They are eligible for reappointment. They elect from among themselves one person as the Chairman of the Board.

The Central Board of Directors should meet at least six times in a year and not less than once in a quarter. Deputy Governors and the official director may attend the meetings of Board but they have no authority to vote. A Deputy Governor may exercise the right to vote, if he is authorized to do so when the Governor is absent. In the absence of the Governor, the Deputy Governor discharges the duties of the Governor and has the right of control over the affairs of the Bank. The Central Office of the Reserve Bank is located in Mumbai.

## Functions of RBI

**1*.* Issuer of Currency Notes**:- It is responsible for issuing currency notes. It brings uniformity in notes issue thus making it easier to control and regulate credit in accordance with the requirements in the economy. This also helps in keeping the faith of the public in the paper currency.

**2. Banker to the Government**:- As banker to the government the Reserve Bank manages the banking needs of the government. It maintains and operates the government’s deposit accounts. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.

**3. Custodian of Cash Reserves of Commercial Banks**:- The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks. The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country’s banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors’ interest and provide cost-effective banking services to the public. It decides policy rates and reserve ratios.

**4. Custodian of Country’s Foreign Currency Reserves**:- The Reserve Bank has the custody of the country’s reserves of international currency, and this enables the Reserve Bank to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

**5. Lender of Last Resort**:- The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

**6. Central Clearance and Accounts Settlement**:- Commercial banks have their surplus cash reserves deposited in the Reserve Bank, it is easier to deal with each other and settle the claim of each on the other through book keeping entries in the books of the Reserve Bank. The clearing of accounts has now become an essential function of the Reserve Bank

**7. Controller of Credit**:- Since credit money forms the most important part of supply of money, and since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government.

**8. Detection of Fake Currency**:- Reserve Bank is expected to unearth black money held in cash. As the new currency notes (demonetization) have added security features, they would help in curbing the menace of fake currency.

**Role of RBI**

1. **Note issuing authority**: - The RBI has the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins, and coins of smaller denominations.
2. **Government Banker**: - The RBI is the banker to the Central and state governments. As a banker to the Govt. , the bank can make “ ways and means advances” to both the Central and State Govt. and also provides overdraft facilities .
3. **Banker’s bank**:-The RBI can be called a banker’s bank because it has a very special relationship with commercial and co-operative banks, and the major part of its business is with these banks.
4. **Supervising Authority**: - The RBI has the power to supervise and control commercial and co-operative banks i.e to issue licenses for starting branches, to inspect the working of banks in India.
5. **Exchange Control Authority**: - RBI also performs the role of maintaining the stability of external value of rupee. It pursues this objective through its domestic policies and regulation of foreign exchange market
6. **Promoter of Financial System: -** RBI has been rendering ‘development’ or ‘promotional services’ which have strengthened the country’s banking and financial structure.
7. **Banking Ombudsman Scheme**: - RBI introduced the Banking Ombudsman Scheme in 1995. Under this scheme, the complainants can file their complaints in any form , including online and can also appeal to the RBI against the awards and the other decisions of the Banking Ombudsman.
8. **Monetary Policy implementation**: - RBI implements the monetary policy through its various instruments.
9. **Banking Codes and Standards Board of India** :- To measure the performance of banks against Codes and standards based on established global practices ,the RBI set up the Banking Codes and Standards Board of India(BCSBI).
10. **Customer Service Department in RBI**: - RBI set up a new department called Customer Service Department to carry out a variety of activities relating customer services and grievance redressal in the RBI.
11. **Fair Practices Codes For Lenders**:- RBI formulated the Fair Practices Code for Lenders which was communicated to banks to safeguard the rightful interest of the borrowers .
12. **Transparency and reasonableness of bank charges**:- there should be transparency and reasonableness of bank charges.

**NABARD (**National bank of Agriculture and Rural Development)

NABARD is a Development Bank with a mandate for providing and regulating credit and other facilities for promotion and development of agriculture ,small scale industries ,cottage and village industries, handcraft and other rural craft or any economic activity in rural areas with a view to promote integrated rural development and securing prosperity of rural areas .

**ESTABLISHMENT:** It was set up on July 12, 1982 under an Act of Parliament as a central or apex institution for financing agriculture and rural sector.

**Organizational structure:** The Structure of NABARD comprises of Board of Directors, Chairman, Managing Director , 2 Executive Director .They All look after 26 Head Office Department ,28 Regional Offices ,6 Training Establishment. There are 391 District Development Offices and one Sub Office Special Cell under the Regional Offices.



**Role of NABARD:**

* Act as coordinator in operation of Rural Credit Institution.
* It gives assistance to the government, RBI and other organization in matter relating to rural development.
* It offers training and research facility for banks, cooperatives and other organization working in rural field.
* Act as regulator of Cooperative Banks and RRBs.
* It has been associate with the implementation of the many project from Word Bank and International Funds for Agriculture Development.(IFDA)

**Function of NABARD:**

* Credit Function :

1. Framing policy and guideline for rural financial institution.
2. Providing credit facilities to issuing organization
3. Monitoring the flow of ground level rural credit.

* Financial Function:

1. It provides short term and medium term loans to RRBs (Regional Rural Bank), CCBs (central Cooperative bank) and SCBs (state Cooperative banks) and other institution involve in Agriculture and rural development.
2. It provides long term loan to the Agriculture and allied activities, Artisans, small scale industries, Handcrafts and other non form sectors.
3. It directly finances the ware houses, cold storage and cold chain infrastructures also for food parks and food processing units.

* Development Function:

1. Help Cooperative banks and other rural banks to prepare their action plan.
2. Monitor implementation of development action plan of banks and fulfillment of obligation under MoU.
3. Provide financial support to training institutes of cooperative banks.
4. Helping in development of farm and non farm sector by giving financial, technical, educational and other supports.

* Supervisory Action:

1. Undertake inspection of RRBs, Cooperative Banks, SCARDBs and apex non credit cooperative societies.

**Schedule commercial Banks**

**Introduction**

Banks in India can be categorized into two parts:

a) Scheduled Commercial banks and

b) Unscheduled Commercial Banks.

Those banks which fulfill the conditions laid down by the Second Schedule of Reserve Bank of India Act 1934, vide section 42 (6), are called Scheduled Commercial Banks and other banks are known as Unscheduled Commercial Banks. (A non scheduled bank is a bank which does not come under RBI act 1949)

The banks included in this schedule list should fulfill two conditions.

1. The paid capital and collected funds of bank should not be less than Rs. 5 lack.

2. Any activity of the bank will not adversely affect the interests of depositors.

Every Scheduled bank enjoys the following facilities.

* 1. Such bank becomes eligible for debts/loans on bank rate from the RBI
  2. Such banks automatically acquire the membership of clearing house.
  3. Scheduled Banks of India can be further categorized into

– Public Sector Banks

– Private Sector Banks

– Foreign Banks

– Regional rural bank

1. Public Sector Banks are widely known as nationalized banks of India.

**Public Sector Banks**: - are those banks in which majority of stake are held by the government. **Eg-**

* Allahabad Bank
* Andhra Bank
* Bank of Baroda
* Bank of India
* Bank of Maharashtra
* Canara Bank
* Central Bank of India
* Corporation Bank
* Dena Bank
* IDBI Bank (Industrial Development Bank of India)
* Indian Bank
* Indian Overseas Bank
* Oriental Bank of Commerce

**Private Sector Banks: -** are those banks in which majority of stake are held by private Individuals.

**Eg:-**

* Abhyudaya Bank
* Axis Bank Ltd
* Bank of Punjab Ltd
* Bank of Rajasthan
* Catholic Syrian Bank
* Centurion Bank Ltd
* City Union Bank Development Credit Bank
* Dhanlaxmi Bank
* Federal Bank Ltd
* HDFC Bank Ltd
* ICICI Banking Corporation Bank Ltd

**Foreign Banks**: - are the banks with Head office outside the country in which they are located. **Eg:-**

* American Express Bank Ltd.
* ANZ Bank Bank of Tokyo Ltd.
* Banque Nationale de Paris
* Barclays Bank Plc
* The Royal Bank of Scotland
* Standard Chartered Bank

**Regional Rural Banks** - are the banking organizations being operated in different states of India. They have been created to serve the rural areas with banking and financial services. **Eg**

* Karnataka Vikas Grameena Bank
* Narmada Malwa Grameena Bank
* Pragathi Grameena Bank
* Cauvery Kalpatharu Grameena Bank
* Saptagiri Grameena Bank
* Shri Venkateswara Grameena Bank
* Kisan Grameena Bank
* Chaitanya Grameena Bank

**Functions**

* **Accepting Deposits**: accepts various types of deposits from public especially from its clients. It includes saving account deposits, recurring account deposits, fixed deposits, etc.
* **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 term loans to all types of clients against proper security.
* **Credit creation**: 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.
* **Agency Functions**: Various agency functions of Scheduled commercial banks are

1. To collect and clear cheque, dividends and interest warrant.
2. To make payment of rent, insurance premium, etc.
3. To deal in foreign exchange transactions.
4. To purchase and sell securities.
5. To accept tax proceeds and tax returns.

* **General Utility Functions**: The general utility functions of the scheduled commercial banks include

1. To provide safety locker facility to customers.
2. To provide money transfer facility.
3. To issue traveler's cheque.
4. To act as referees.
5. To accept various bills for payment e.g. phone bills, gas bills, water bills, etc.
6. To provide merchant banking facility.
7. To provide various cards such as credit cards, debit cards, Smart cards, etc.

**Regional Rural Bank**

Regional rural banks are basically, banking organization for local level operations across the States in India. They are created with a mandate to provide essential or basic banking and financial services to the rural areas. While Regional Rural Banks are meant for rural areas, they can operate in urban areas also. The main purpose behind setting up the RRBs is to mobilize financial resources from the rural areas and grant loans to needy and marginal farmers and artisans. They also facilitate the movement of government funds to MGNREGA workers, or distribution of pension.

**History of Regional Rural Banks**

The Regional Rural Banks were established on the recommendations of Narsimha Committee on Rural Credit. The committee was of the view that RRBs would be much better suited than the commercial banks or Co-Operative Banks in meeting the needs of rural areas. Considering the recommendations of the committee the Government of India passed Regional Rural Banks Act 1976. After passing the Act within a year at least 25 RRBs were established in different parts of India.

The Regional Rural Banks were established with a view to develop such type of banking institutions which could function as a commercial organization in rural areas. The Regional Rural Banks Act 1976 provide for incorporation, regulation and winding up Regional Rural Banks with a view to developing the rural economy by providing for the purpose of development of Agriculture, Trade, Commerce, Industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, Agricultural Labourers, Artisans and small entrepreneurs and for matters connected therewith and individuals thereto.

**Structure and Organization of the RRB:**

The authorized capital of an RRB is fixed at Rs. 1 crore and its issued capital at Rs. 2 lakhs. Of the issued capital, 50 per cent is to be subscribed by the Central Government, 15 per cent by the concerned State Government and the rest 35 per cent by the sponsoring bank.

The working and affairs of the RRB are directed and managed by a Board of Directors consists of a Chairman, three directors to be nominated by the Central Government, and not more than two directors to be nominated by the State Government concerned, and not more than 3 directors to be nominated by the sponsoring bank. The chairman is appointed by the Central Government and his term of office does not exceed five years.

## ****Objectives of Regional Rural Banks****

* To bridge the credit gap in rural regions in India.
* To check rural credit outflow to urban areas.
* To reduce regional imbalances in terms of availability of financial facilities.
* To increase rural employment generation.

**Functions of the RRB:**

* Granting of loans and advances to small and marginal farmers and agricultural laborers, whether individually or in groups, and to co-operative societies, agricultural processing societies, co-operative farming societies, primarily for agricultural purposes or for agricultural operations and other related purposes.
* Granting of loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade, commerce and industry or other productive activities within its area of co-operation.
* Accepting deposits.

**Cooperative Banking**

Co-operative banks are financial entities established on a co-operative basis and belonging to their members. This means that the customers of a co-operative bank are also its owners. These banks provide a wide range of regular banking and financial services. However, there are some points where they differ from other banks.

**History of Cooperative Banking in India:**

Cooperative movement in India was started primarily for dealing with the problem of rural credit. The history of Indian cooperative banking started with the passing of Cooperative Societies Act in 1904. The objective of this Act was to establish cooperative credit societies “to encourage thrift, self-help and cooperation among agriculturists, artisans and persons of limited means.”

Many cooperative credit societies were set up under this Act. The Cooperative Societies Act, 1912 recognized the need for establishing new organizations for supervision, auditing and supply of cooperative credit. These organizations were- (a) A union, consisting of primary societies; (b) the central banks; and (c) provincial banks.

Although beginning has been in the direction of establishing cooperative societies and extending cooperative credit, but the progress remained unsatisfactory in the pre-independence period. Even after being in operation for half a century, the cooperative credit formed only 3.1 per cent of the total rural credit in 1951-52.

**Structure of co-operative banks in India**

Co-operative banks in India are divided into two categories - urban and rural.

* Rural cooperative credit institutions could either be short-term or long-term in nature. Further, short-term cooperative credit institutions are further sub-divided into State Co-operative Banks, District Central Co-operative Banks, and Primary Agricultural Credit Societies. Meanwhile, the long-term institutions are either State Cooperative Agriculture or Rural Development Banks (SCARDBs) or Primary Cooperative Agriculture and Rural Development Banks (PCARDBs).
* Urban Co-operative Banks (UBBs) are either scheduled or non-scheduled. Scheduled and non-scheduled UCBs are again of two kinds- multi-state and those operating in single state.

**Type of cooperative bank**

* 1. **State Cooperative Banks (SCBs):-** These are the apex (highest level) co-operative banks in all the states of the country. They mobilize funds and help in its proper channelization among various sectors. The money reaches the individual borrowers from the state cooperative banks through the central co-operative banks and the primary credit societies.
  2. **Central Cooperative Banks:-** These banks operate at the district level having some of the primary credit societies belonging to the same district as their members. These banks provide loans to their members (i.e., primary credit societies) and function as a link between the primary credit societies and state co-operative banks.
  3. **Primary Credit Societies: -** These are formed at the village or town level with the borrower and non-borrower members residing in one locality. The operations of each society are restricted to a small area so that the members know each other and are able to watch over the activities of all members to prevent frauds.

**FUNCTIONS OF CO-OPERATIVE BANK**

* Co-operative Banks are organized and managed on the principal of co-operation, self-help, and mutual help. They work on the basis of “no profit no loss”. Profit maximization is not their goal.
* Co-operative bank do banking business mainly in the agriculture and rural sector. However, UCBs, SCBs, and CCBs operate in semi urban, urban, and metropolitan areas also.

**Private Banks**

Private Sector Banks refer to those banks where most of the capital is in private hands. In India, there are two types of private sector banks viz. Old Private Sector Banks and New Private Sector Banks. Old private sector banks are those which existed in India at the time of nationalization of major banks but were not nationalized due to their small size or some other reason. After the banking reforms, these banks got license to continue and have existed in India along with new private banks and government banks.

**Old Private Banks**:-

* Catholic Syrian Bank City
* Union Bank
* Dhanlaxmi Bank

**New Private Sector Banks:-**

* HDFC Bank
* ICICI Bank

## Products and services offered by private banks

While the specific services offered vary from bank to bank, private bankers may offer these services to their clients:

* **Deposit accounts (checking, savings, money market, CDs):** High-net-worth individuals often qualify for preferential pricing, such as a slightly higher savings interest rate than standard accounts would get.
* **Investment planning services:** Private bankers draw up custom investment strategies and create portfolios to meet their clients' goals and objectives.
* **Real estate financing and advice:** Private Banks helps clients obtain loans for a primary or secondary home, as well as financing for investment real estate.
* **Lending:** In addition to mortgage lending, private banks often offer specialized types of loans to their high-net-worth clients. These may include aircraft, yacht, and fine art financing. In addition, private banks may offer flexible lines of credit, secured by the client's account.
* **Tax planning:** Private bankers help clients plan for current tax laws, as well as potential changes in the future.
* **Bill and cash flow management:** Private bankers help clients manage their everyday cash flow, and may handle bill payments.
* **Risk management solutions:** Private bankers can help their clients protect against interest rate fluctuations, foreign exchange risk, and liquidity risks.
* **Estate planning services:** Private banks help clients plan for passing their wealth to future generations.
* **Custom credit strategies:** The "strategic borrowing" example I mentioned earlier would be a custom credit strategy.

## Other types of banking

In addition to private banking, there are several other varieties of banking products and services, including:

* **Retail banking:** This is what most people think of when they hear the word "bank." Retail banking refers to any banking services that are intended for everyday consumers. This includes checking and savings accounts, credit cards, mortgages, auto loans, CDs, and more.
* **Commercial banking:**Commercial banking refers to financial services provided to the corporate or institutional world. Many of the products offered by commercial banks are similar to those offered by retail banks, such as savings and checking accounts, but commercial banks may also offer things like foreign trade services, treasury management services, merchant services, and more.
* **Investment banking:**Investment banks provide services to corporations, governments, and individuals. These services include raising financial capital by underwriting debt or equity issuances, and assisting in mergers and acquisitions. Investment banks can also engage in market-making activities and trading.

# Importance of Private Sector Banks

The private sector banks play a vital role in the Indian economy. They indirectly moti­vate the public sector banks by offering a healthy competition to them. The following are their importance:

* **Offering high degree of Professional Management:** - The private sector banks help in introducing a high degree of professional management and marketing concept into banking. It helps the public sector banks as well to develop similar skill and technology.
* **Creates healthy competition:** - The private sector banks provide a healthy competition on general efficiency levels in the banking system.
* **Encourages Foreign Investment:**-The private sector banks especially the foreign banks have much influence on the foreign investment in the country.
* **Helps to access foreign capital markets:** - The foreign banks in the private sector help the Indian companies and the government agencies to meet out their financial requirements from international capital markets. This service becomes easier for them because of the presence of their head offices/other branches in important foreign centers. In this way they help a large extent in the promotion of trade and industry in the country.
* **Helps to develop innovation and achieve expertise:** - The private sector banks are always trying to innovate new products avenues (new schemes, services, etc.) and make the indus­tries to achieve expertise in their respective fields by offering quality service and guidance. They introduce new technology in the banking service. Thus, they lead the other banks in various new fields. For example, introduction of computerized operations, credit card busi­ness, ATM service, etc.

**Foreign Bank**

A type of foreign bank is that obligated to follow the regulations of both the home and host countries. Because the foreign branch banks loan limits are based on the parent banks capital, foreign banks can provide more loans than subsidiary banks. For example, suppose the SBI opens a foreign branch bank in America. The branch would be legally obligated to follow both Indian and American banking regulations.

**Services of Foreign Banks in India**

The Foreign Banks in India provide the following services under the different sections:

* Credit cards
* Debit cum ATM cards
* Touch Screen Banking
* Mobile Banking
* Online Payment of Bills
* Bank statements through Email
* Loans which include home loans, business loans, personal loans, overdrafts
* Internet Banking
* Prepaid Mobile Recharge
* Insurance services which include Health insurance, Life Insurance,
* insurance on home loans and travel insurance
* Investment Services which include Demat, Mutual Funds
* Deposits

List of Foreign Banks in India:-

* ABN-AMRO Bank
* Abu Dhabi Commercial Bank
* Bank of Ceylon
* BNP Paribas Bank
* Citi Bank
* China Trust Commercial Bank
* Deutsche Bank
* HSBC
* JPMorgan Chase Bank
* Standard Chartered Bank
* Scotia Bank
* Taib Bank

**Non-Banking Financial Companies**

A **non-banking financial company (NBFC)** is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Indian government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme of arrangement or any other manner, or lending in any manner is also a NBFC (residuary non-banking company i.e. RNBC).

**Importance: -** Non banking financial institutions have the following importance in Indian economy.

* Greater reach.
* Flexibility in tapping resources.
* Retail services to small and medium business.
* Important component of financial market.

**Role of NBFIs**

* Development of sectors like Transport & Infrastructure
* Substantial employment generation
* Help & increase wealth creation
* Broad base economic development
* To finance economically weaker sections

**FUNCTIONS**

* Brokers of loan able funds.
* Mobilization of savings.
* Channelization of funds into investment,
* Stabilize the capital market,
* Provide liquidity

**Regulations: -** RBI Act, 1934, it is mandatory that every NBFI should be registered with RBI to commence or carry on any business of non-banking financial institution**.**

**TYPES**

* **Risk-pooling institutions**: - Insurance companies underwrite economic risks associated with illness, death, damage and other risks of loss. There are two main types of insurance companies: (a) general insurance (b) life insurance.
* **Contractual savings institutions**: Contractual savings institutions (also called institutional investors) give individuals the opportunity to invest in collective investment vehicles (CIV). Collective investment vehicles pool resources from individuals and firms into various financial instruments including equity, debt and derivatives. Eg- mutual funds, pension funds.
* **Market makers: -** Market makers are broker-dealer institutions that quote a buy and sell price and facilitate transactions for financial assets. Such assets include equities, government and corporate debt, derivatives, and foreign currencies.
* **Specialized sectoral financiers**: - They provide a limited range of financial services to a targeted sector. For example, real estate financiers channel capital to prospective homeowners, leasing companies provide financing for equipment and payday lending companies that provide short term loans to individuals that are under banked or have limited resources.
* **Financial service providers: -** Financial service providers include broker’s management consultants, and financial advisors, and they operate on a fee-for-service basis. Their services include: improving informational efficiency for the investors and, in the case of brokers, offering a transactions service by which an investor can liquidate existing assets.

**COMPANY’S UNDER NBFC: -** They are also categorized in a different format among 8 categories

* Loan company
* Hire purchase company
* Investment company
* Mutual benefit company
* Housing finance company
* Equipment leasing company

**CONCLUSION: -** Strengthening the professionalism of NBFC sector through education and training, making them more organized. RBI needs to educate people about NBFC.The credit delivery mechanism needs to be more transparent and hassle free. There should be more stringent norms for the defaulters.

**UNIT- 3**

**Topic covered :-**Introduction of Banking operation in India, Role and importance of CIBIL for banks, Camel approach and disclosure requirement for bank financial health, RBI guidelines on KYC policy, source of liquidity risk, key principles for liquidity management, approaches of liquidity management, interest rate risk management concept and functions.

Introduction:- The Banking Companies Act of 1949, defines : Banking Company as a company which transacts the business of banking in India. It defines banking as, accepting for the purpose of lending or investment of deposit money from the public, repayable on demand or otherwise and withdraw able by cheque draft, order or otherwise A bank as an institution dealing in money and credit. It safeguards of the savings of the public and gives loans and advances.

**Stages in History of Banking in India**

• Pre-independence stage

• Post Independence stage

• Nationalization of Banks

• Introduction of Financial Sector Reforms

1. Pre-Independence Stage: - There were three oldest Banks called Presidency Banks.

* Bank of Bengal (Earlier Bank of Calcutta)
* Bank of Bombay
* Bank of Madras

They merged in 1925 to form the Imperial Bank of India, which after independence became State Bank of India. Reserve Bank of India came into existence in 1935 which took the responsibility of regulating Banking sector as Central Bank in India.

1. Post Independence

* In 1948, the Reserve Bank of India was nationalized, and it became an institution owned by the Government of India.
* In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India."

1. Nationalization of Banks

* On July 19, 1969, 14 major banks were nationalized.
* On April 15, 1980 another 6 banks were nationalized.
* With the nationalization, the banking in India shifted from ‘Class’ banking to ‘Mass’ Banking.

1. Liberalization

* In the early 1990s the Govt embarked on a policy of liberalisation and gave licences to a small number of private banks, which came to be known as New Generation tech-savvy banks like Global Trust Bank, UTI Bank(now re- named as Axis Bank), ICICI Bank and HDFC Bank.

**Narasimham Committee**:- The first Narasimham Committee was set up in 1991 to suggest remedial measures for strengthening the banking system encompassing: Banking Policy Institutional Structure Supervisory System Legislative changes technological changes

**Reforms: -** The main thrust of economic reforms was on:

* Removal of structural bottlenecks
* Improvement in trading, clearing and settlement practices
* Introduction of new players and instruments
* Introduction of free pricing of financial assets
* Relaxation of quantitative restrictions
* Promotion of institutional infrastructure
* Ensuring of technological up gradation.

**Banking & Indian Economy**: - A study of the economic history of western country shows that without the evolution of commercial banks in the 18th and 19th centuries, the industrial revolution would not have taken place in Europe. The economic importance of banks to the developing countries may be viewed thus:

* Promoting capital formation
* Encouraging innovation
* Monetsation
* Influence economic activity
* Facilitator of monetary policy

**CIBIL**

Credit Information Bureau (India) Limited is India’s first Credit Information Company (CIC) founded in August 2000. CIBIL collects and maintains records of an individual’s payments pertaining to loans and credit cards. These records are submitted to CIBIL by member banks and credit institutions, on a monthly basis. This information is then used to create Credit Information Reports (CIR) and credit scores which are provided to credit institutions in order to help evaluate and approve loan applications. CIBIL was created to play a critical role in India’s financial system, helping loan providers manage their business and helping consumers secure credit quicker and on better terms.

**Objectives**

* CIBIL collects commercial and consumer credit-related data and collates such data to create and distribute credit reports to its Members which are credit institutions and banks in India.
* CIBIL’s products, especially the Credit Information Report (CIR) and CIBIL Trans union Score are very important in the loan approval process.
* The CIR and Credit Score not only help loan providers identify consumers who are likely to be able to pay back their loans, but also help them to do this more quickly and economically. This translates into faster loan approvals for consumers.
* CIBIL empowers both loan providers and individuals to see their financial and credit history more clearly and hence, take better and more informed decisions.

**HOW DOES CIBIL OPERATES**

* Allows the credit grantors to have access to its database to search and gain a complete picture of the payment history of a credit applicant.
* This information will be supplement by CIBIL with public domain information.
* Collects, Collates and Disseminates credit information of borrowers from its Members (who are actually credit grantors).
* CIBIL does not grant or deny credit.
* CIBIL collects commercial and consumer credit-related data and collates such data to create and distribute credit reports to Members.
* Reports could be obtained from CIBIL only by Members who contribute all data about the borrowers.

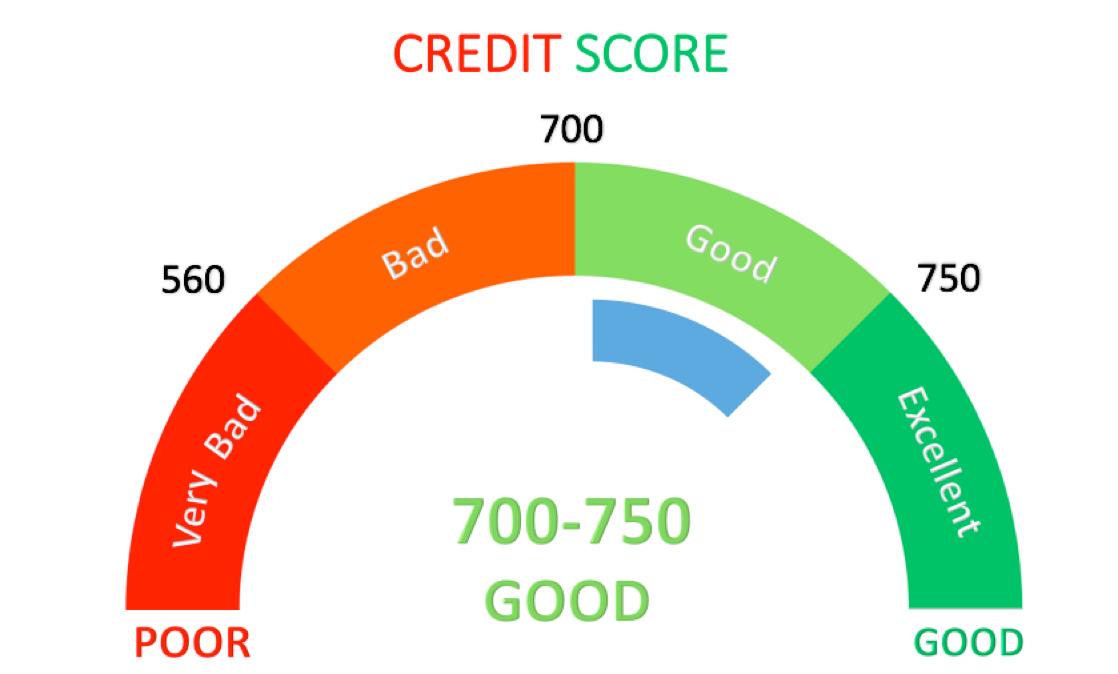
**MEMBERS OF CIBIL**

* Credit Card Companies
* State Financial Corporations
* Housing Finance Companies
* Non Banking Financial Companies
* Financial Institutions
* Banks

**CIBIL – Products & Services**

* + 1. Consumer Credit Information Report (CCIR):-
* With CIRs credit grantors are equipped to identify risk areas, disburse credit faster, with greater efficiency and grow business profitability.
* Provides factual information on credit histories of borrowers enabling institutions to make lending decisions.
* Tool used by credit grantors at the time of new customer acquisitions.
* Based on information database of individual borrowers.
  + 1. Portfolio Review Report:-
* With it, the credit grantor can effectively predict the likelihood of an applicant becoming more than 91 days delinquent on one or more trade lines over the subsequent 12 months.
* India’s first generic score and has become the most trusted indicator for prudent decision making by credit grantors.
  + 1. CIBIL Trans Union Score:-
* Provides the credit grantor with a comprehensive view of their borrower’s credit relationships across multiple lenders.
* An extremely effective tool for credit grantors to review the risk associated with the existing portfolio of customers.
  1. Bureau Credit Characteristics (BCC):- List of predefined characteristics summarizing various aspects of a customer’s credit information.

**Credit Score:-**This score is the result of collaboration between Credit Information Bureau (India) Limited (CIBIL) and Trans Union. First and only score for the Indian market to predict the likelihood of an applicant or customer becoming more than 91 days delinquent on a personal or consumer loan over the next 12 months.



## Advantages

* Cheaper interest rates on loans
* Cards with better benefits and rewards
* Avail pre-approved loans
* Loans with longer tenure
* Quicker approval on credit applications
* Negotiation power
* Discount on loan processing fees and other charges
* Higher credit card limit

**CAMEL**

In 1995, RBI had set up a working group under the chairmanship of Shri S. Padmanabhan to review the banking supervision system and the committee made certain recommendations. Based on such recommendations a rating system for domestic and foreign banks based on the international CAMELS model (combining financial management, systems and control elements) was introduced for the inspection cycle commencing from July 1998. It recommended that the banks should be rated on a five point scale (1 to 5) based on the lines of international CAMELS rating model. The operational efficiency of the Nineteen Central Co-operative Banks of Haryana has been examined through the CAMEL (Capital adequacy, Asset quality, Management efficiency, Earnings quality, and Liquidity position) model. The efficiency parameters in the model are well defined and embedded in a composite frame to rate the operating performance as described below:

C- Capital Adequacy

A-Assets Quality

M- Management Efficiency

E- Earning quality

L- Liquidity Position

**CAMEL Efficiency Parameters: -** The numerals in the braces are CAMEL ratings. The number (1) indicates the highest rating, strongest performance, least degree of supervision concern, and sound health, while (5) indicates lowest rating, inadequate performance and weak health of bank and therefore receiving highest degree of supervisory concern. The efficiency parameters identified in the (CAMEL) model are defined a:-

|  |  |  |  |
| --- | --- | --- | --- |
| S. **..no.** | **Efficiency** **Parameters** | **Measurement** **Ratios** | **Rating (on a five point scale)** |
| 1 | Capital Adequacy | Risk weighted capital to Assets | less than 5 **(5)**, 6-10 **(4)**, 11-15 **(3)**, 16- 20 **(2)**, more than 20 **(1)** |
| 2 | Asset Quality | NPA to Advances | more than 11 **(5)**, 8-10 **(4)**, 5-7 **(3)**, 2 –  4 **(2)**, less than 1 **(1)** |
| 3 | Management Efficiency | Net Profit per Employee | less than 1 **(5)**, 1 – 2 **(4)**, 2 – 3 **(3)**, 3 – 4 **(2)**, more than 5 **(1)** |
| 4 | Earning Quality | Profit to Average Assets | 0-0.5 **(5)**,0.6-1.0 **(4)**,1.1-1.5 **(3)**, 1.6- 2.0 **(2)**, more than 2.0 **(1)** |
| 5 | Liquidity Position | Cash to Deposits | less than 5 **(5)**, 6 – 9 **(4)**, 10-12 **(3)**, 13- 15 **(2)**, more than 15 **(1)** |

* + 1. **Capital Adequacy (risk weighted capital to assets):** It reflects the financial condition of a bank to meet additional requirement of funds. It specifies the quality and level of capital required in a bank. The capital adequacy indicators are rated as per description given below: \

**CAMEL Model – Capital Adequacy Indicator(s) Rating Indicator(s)**

* Strong capital level that adequately support the risk profile.
* Overall satisfactory level of capital that fairly support the bank’s risk profile
* Less than satisfactory level of capital that does not fully support the bank’s risk profile.
* Deficient level of capital signifying a need for external (additional) capital.
* Inadequate capital signifying an urgent need for external capital to sustain the operations.
  + 1. **Asset quality (NPA to advances):** It is judged in terms of potential credit risk associated with the lending. It is a testing instrument to reflect the ability of management in discovering and controlling risk. The assets quality rating is assigned as per the description given below:

**CAMEL Model – Asset Quality Indicator(s) Rating Indicator(s)**

* Strong asset quality and very good credit monitoring and administration.
* Satisfactory asset quality and credit monitoring and administration.
* Less than satisfactory level of asset quality to call for improving bank’s credit administration and risk management practices.
* Poor credit administration and monitoring signifying an urgent improve risk management for viability of the bank.
* Critically deficient asset quality severely affecting bank viability.
  + 1. **Management Efficiency (net profit to employees)**: It is measured evaluation of management and is subjective in nature. In this research study net profit per employee is used to suggest whether the manpower is efficiently utilized by the bank. The management efficiency rating is assigned as per the description given below:

**CAMEL Model – Management Efficiency Indicator(s) Rating Indicator(s)**

* Indicates higher efficiency of employees of the bank.
* Indicates satisfactory levels of efficiency of management that can be improved further.
* Indicates less than satisfactory level of management efficiency of the bank. There is an urgent need for the bank to improve on its net profit.
* Indicates a poor level of management efficiency of the bank. This shows that the bank is not properly utilizing its manpower and is in serious trouble as far as efficiency of management is concerned.
* Indicates a critically deficient management efficiency of bank. This may be due to failure of the bank to deploy its work force effectively.
  + 1. **Earnings Quality (net profit after tax to average assets):** The earning of a bank reflects its growth capacity and financial health. In the present study, earnings quality of a bank is measured in terms of return on assets. A higher value of ROA denotes higher profitability and high CAMEL rating for the bank. The earning quality rating is assigned as per the description given below:

**CAMEL Model – Earnings Quality Indicator(s) Rating Indicator(s)**

* Indicates strong earnings quality, more than sufficient to meet its operational and other expenses, after having sufficient provisions for adequate capital levels.
* Indicates satisfactory level of earnings quality to maintain adequate capital level and meet its operational and other expenses.
* Indicates less than satisfactory level of earnings barely sufficient to meet its expenses.
* Indicates poor earnings quality of the bank, not sufficient to meet its expenses.
* Indicates a critically deficient level of earnings quality and the bank may face the threat of losing its capital.
  + 1. **(v) Liquidity Position (cash to deposit):** Liquidity in a bank implies the cash position of a bank and ability of a bank to meet its day to day cash needs. However, sometimes due to various reasons, a bank may suddenly experience huge withdrawals. In this study, the liquidity of a bank is measured by using cash to deposit ratio. The liquidity position rating is assigned as per the description given below:

**CAMEL Model – Liquidity Position Indicator(s) Rating Indicator (s)**

* Indicates strong liquidity level of the bank.
* Indicates satisfactory liquidity levels and better fund management by the bank.
* Indicates less than satisfactory level of liquidity position. There is some sense of weakness with the bank’s fund management practices.
* Indicates a poor level of liquidity position of the bank. The bank may not be able to meet present and anticipated sudden withdrawals.
* Indicates a critically deficient liquidity position, external assistance needed to tide over the liquidity crunch.

### Sensitivity

The effect of market fluctuations on the financial institutions, such as the response to changes in interest rates, commodity price, foreign exchange rates, derivatives, etc.

**Rating Factors of Sensitivity**:

* Management efficiency in identifying, analyzing and controlling the level of market risk;
* Analysis of the interest rate risk involved in non-trading positions;
* Responsiveness of the financial institutions towards the fluctuation in commodity prices, interest rates, equity prices, foreign exchange rates, etc.;
* Assess trading and international operations risk.

**Purpose of CAMELS Rating System**

The CAMELS rating system is highly efficient to determine the risk level associated with financial institutions. It has majorly served the following purposes:



* *Financial Condition*: To determine the financial health and soundness of the institution, the CAMELS rating system is widely used.
* *Operational Condition*: CAMELS rating system analyzes the institution’s liquidity position and manages risk is to ensure sound operational condition.
* *Managerial Condition*: It also indicates management’s efficiency of handling risks, managing sources of funds, liquidity position and earnings potential of the institution.

**RBI GUIDELINE ON KYC POLICY**

KYC (Know Your Customer)

It is a framework for banks which enables them to know / understand the customers and their financial dealings to be able to serve them better. Banking operations are susceptible to the risks of money laundering and terrorist financing. Therefore, banks are advised to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority.

Any contravention of the same will attract penalties under the relevant provisions of the Act. Thus, the Bank has to be fully compliant with the provisions of the KYC procedures. Reserve Bank of India has advised banks to make the Know Your Customer (KYC) procedures mandatory while opening and operating the accounts and has issued the KYC guidelines under Section 35 (A) of the Banking Regulation Act, 1949.

**KYC Means**

* Customer: - One, who maintains an account, establishes business relationship, on whose behalf account is maintained, beneficiary of accounts maintained by intermediaries, and one who carries potential risk through one off transaction.
* Your? Who should know? Branch manager, audit officer, monitoring officials, PO.
* Know? What you should know? True identity and beneficial ownership of the accounts permanent address, registered & administrative address sources of funds, nature of customers’ business etc.

**When does KYC apply:-**

* Opening a new account.
* For non-account holders approaching the Bank for high value one-off transactions like Drafts, Remittances etc.
* When there are changes to signatories, mandate holders, beneficial owners etc.
* When the Bank feels it necessary to obtain additional information from existing customers based on conduct of account.
* Opening a Locker Facility where these documents are not available with the Bank for all the Locker facility holders.
* In respect of accounts where documents as per current KYC standards have not been submitted while opening the initial account.

**Advantages**

* They help to protect banks’ reputation and the integrity of banking systems by reducing the likelihood of banks becoming a vehicle for or a victim of financial crime and suffering consequential reputational damage.
* They provide an essential part of sound risk management system (basis for identifying, limiting and controlling risk exposures in assets & liabilities.

**Element of KYC Policy: -**

* Risk management
* Monitoring of Transactions
* Customer Identification Procedures;
* Customer Acceptance Policy.

**Customer acceptance policy:-**

* Not to open an account or close an existing account where the bank is unable to apply appropriate customer due diligence.
* Necessary checks before opening a new account.
* Circumstances, in which a customer is permitted to act on behalf of another person/entity, should be clearly spelt out.
* Documentation requirements and other information to be collected.
* Parameters of risk perception are clearly defined.
* No account is opened in anonymous.

**Customer Identification Process:-**

* Identifying the customer and verifying his/ her identity by using reliable, independent source documents, data or information.
* The policy approved by the Board of banks should clearly spell out the Customer Identification Procedure to be carried out at different stages i.e. while establishing a banking relationship. i.e. while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer identification data.

**LIQUIDITY**

Ability to meet anticipated and contingent cash needs. Cash needs may arise from withdrawal of deposits, liability maturities' and loan disbursals. A minimum criterion of liquidity is the ability both to meet commitments when due and to undertake new transactions when desirable.

**Estimating liquidity needs**

* Banks strive to maintain adequate liquidity- too much liquidity needlessly limits bank earnings, and too little liquidity exposes a bank to the possibility of costly emergency measures to secure needed funds.
* Liquidity should be sufficient to cover probable fluctuations in loans and deposits, with a small margin of excess liquidity as a safety measure.
* If a bank has carefully evaluated and planned for its liquidity needs, it should hold a maximum liquidity when deposits are up and loan demand is down.

**Liquidity risk: - There are three types of liquidity risks:-**

1. **Funding Risk: -** It depends on the perception of the market of the credit standing of the bank. A bank approaching the market with unexpected and frequent needs for funds would have adverse affect on the willingness of the market to lend and raises the cost of funds which is the prime driver of profitability.
2. **Asset Liquidity Risk: -** It arises when assets are not readily tradable. The rationale of liquidity ratio is to make banks hold more short-term assets than short-term liabilities. Liquidity risk arises when maturities of assets exceed those of liabilities.
3. **Interest Rate Risk: -** Liquidity risk is closely related to interest rate risk. If a bank desires to have more interest sensitive liabilities than assets it reduces the liquidity position of banks. When a bank structure its portfolio in order to achieve a positive duration gap (assets>liabilities), the liquidity of the assets is reduced. If interest rate increases the value of long-duration assets will decline more than short-duration assets and assets sales would involve losses.

**MANAGEMENT OF LIQUIDITY**

* In the context of increased competition and decreased profit margins, the need to improve efficiency of operation through competent liquidity management has become imperative.
* Liquidity management consists of estimating the requirements for funds and meeting them. Funds requirement depends upon deposit inflows and outflows and loan commitments.
* A bank should devise a liquidity plan or strategy that balances risks and returns.
* Liquidity needs arising from deposits withdrawals and loan demands can be estimated by preparing a sources and uses of funds statements.
* The sources and uses approachcan be used to evaluate the effects of deposit inflows and outflows and changing loan demands on bank liquidity.
* The structure of deposits method consisting of a list of different types of deposit and the probability is another way to estimate liquidity needs.

**INSTRUMENTS OF LIQUIDITY**

Banks traditionally have planned for liquidity through their asset portfolios, constructing them so that some assets can and will be liquidated as funds are needed. More recently bankers have found that they can also secure needed liquidity by increasing their liabilities. Thus, bankers have 2 sources of managing liquidity:

1. Liquid assets
2. Liquid liabilities
   * 1. **Liquid assets:-**

* Cash in hand-This includes the cash balance maintained by a bank with itself. The quantum of such cash balance depends upon the experience and circumstances of each individual bank and no hard and fast rules can be laid down.
* Statutory Liquidity Ratio- Statutory Liquidity Ratio refers to the amount that the commercial banks require to maintain in the form of cash or gold or govt. approved securities before providing credit to the customers. It is determined as percentage of total demand and percentage of time liabilities.
* Balances with other banks- The cash balances maintained by banks either with themselves or in current accounts with the RBI are the most liquid assets and therefore, they can rightly be termed as the first line of defense in times of trouble.
* Money at call and short notice- These loans represents mainly the loans given by one bank to another for a short period.
* Investments- The banks also invest a significant portion of their funds in stock exchange securities. These constitute the third line of defensein times of emergencies. These securities mainly include:
* Government securities-They may be of 3 types
  1. Stocks b) Bearer bonds c) Promissory notes
* Semi-government securities- These includes debentures or bonds issued by quasi- government organizations like improvement Trusts, Municipal Corporations.
* Shares and Debentures of joint companies- It is done by commercial banks on a very marginal scale because of uncertainty both regarding return as well as value.
  + 1. **Liquid Liabilities:**
* Time Certificates of Deposits**-** They are negotiable and can be sold by the holder in the market. These certificates bear different maturities ranging from ninety days to one year and are offers with the interest rates competitive with treasury bills and other similar money market instruments.
* Borrowing from other commercial banks**-** The second way in which the individual commercial bank may create additional liabilities in order to acquire reserves is by borrowing from other banks. Such loans are given on a one-day, unsecured basis. Rate on bank loans is very sensitive to changing trends of supply and demand in the money market.
* Borrowing from Central Bank**-** Central bank facilities are available generally in the form of discounting or advance to meet day-to-day and seasonal liquidity needs of commercial banks registered with the central bank. Normally such loans are relatively costlier and are available at restrictive terms.
* Raising of Capital Funds- Commercial banks can acquire reserves by issue of shares carrying different features to suit varying notions of investors. Availability of funds through this source would depend on public response to bank shares which in its turn is essential conditioned by current dividend rate and growth prospect associated with it.

# Liquidity Management Theory/ Approaches

## Commercial Loan Theory: - The commercial loan or the real bills doctrine theory states that a commercial bank should forward only short-term self-liquidating productive loans to business organizations. Loans meant to finance the production, and evolution of goods through the successive phases of production, storage, transportation, and distribution are considered as self-liquidating loans.

This theory also states that whenever commercial banks make short term self-liquidating productive loans, the central bank should lend to the banks on the security of such short-term loans. This principle assures that the appropriate degree of liquidity for each bank and appropriate money supply for the whole economy.

The central bank was expected to increase or erase bank reserves by rediscounting approved loans. When business started growing and the requirements of trade increased, banks were able to capture additional reserves by rediscounting bills with the central banks. When business went down and the requirements of trade declined, the volume of rediscounting of bills would fall, the supply of bank reserves and the amount of bank credit and money would also contract.

### Advantages

These short-term self-liquidating productive loans acquire three advantages. First, they acquire liquidity so they automatically liquidate themselves. Second, as they mature in the short run and are for productive ambitions, there is no risk of their running to bad debts. Third, such loans are high on productivity and earn income for the banks.

### Disadvantages

Despite the advantages, the commercial loan theory has certain defects. First, if a bank declines to grant loan until the old loan is repaid, the disheartened borrower will have to minimize production which will ultimately affect business activity. If all the banks pursue the same rule, this may result in reduction in the money supply and cost in the community. As a result, it makes it impossible for existing debtors to repay their loans in time.

Second, this theory believes that loans are self-liquidating under normal economic circumstances. If there is depression, production and trade deteriorate and the debtor fails to repay the debt at maturity.

Third, this theory disregards the fact that the liquidity of a bank relies on the salability of its liquid assets and not on real trade bills. It assures safety, liquidity and profitability. The bank need not depend on maturities in time of trouble.

Fourth, the general demerit of this theory is that no loan is self-liquidating. A loan given to a retailer is not self-liquidating if the items purchased are not sold to consumers and stay with the retailer. In simple words a loan to be successful engages a third party. In this case the consumers are the third party, besides the lender and the borrower.

## Shiftability Theory:- This theory was proposed by H.G. Moulton who insisted that if the commercial banks continue a substantial amount of assets that can be moved to other banks for cash without any loss of material. In case of requirement, there is no need to depend on maturities.

This theory states that, for an asset to be perfectly shiftable, it must be directly transferable without any loss of capital loss when there is a need for liquidity. This is specifically used for short term market investments, like treasury bills and bills of exchange which can be directly sold whenever there is a need to raise funds by banks.

But in general circumstances when all banks require liquidity, the shiftability theory need all banks to acquire such assets which can be shifted on to the central bank which is the lender of the last resort.

### Advantage

The shiftability theory has positive elements of truth. Now banks obtain sound assets which can be shifted on to other banks. Shares and debentures of large enterprises are welcomed as liquid assets accompanied by treasury bills and bills of exchange. This has motivated term lending by banks.

### Disadvantage

Shiftability theory has its own demerits. Firstly, only shiftability of assets does not provide liquidity to the banking system. It completely relies on the economic conditions. Secondly, this theory neglects acute depression, the shares and debentures cannot be shifted to others by the banks. In such a situation, there are no buyers and all who possess them want to sell them. Third, a single bank may have shiftable assets in sufficient quantities but if it tries to sell them when there is a run on the bank, it may adversely affect the entire banking system. Fourth, if all the banks simultaneously start shifting their assets, it would have disastrous effects on both the lenders and the borrowers.

## Anticipated Income Theory:- This theory was proposed by H.V. Prochanow in 1944 on the basis of the practice of extending term loans by the US commercial banks. This theory states that irrespective of the nature and feature of a borrower’s business, the bank plans the liquidation of the term-loan from the expected income of the borrower. A term-loan is for a period exceeding one year and extending to a period less than five years.

It is admitted against the hypothecation (pledge as security) of machinery, stock and even immovable property. The bank puts limitations on the financial activities of the borrower while lending this loan. While lending a loan, the bank considers security along with the anticipated earnings of the borrower. So a loan by the bank gets repaid by the future earnings of the borrower in installments, rather giving a lump sum at the maturity of the loan.

### Advantages

This theory dominates the commercial loan theory and the shiftability theory as it satisfies the three major objectives of liquidity, safety and profitability. Liquidity is settled to the bank when the borrower saves and repays the loan regularly after certain period of time in installments. It fulfills the safety principle as the bank permits a relying on good security as well as the ability of the borrower to repay the loan. The bank can use its excess reserves in lending term-loan and is convinced of a regular income. Lastly, the term-loan is highly profitable for the business community which collects funds for medium-terms.

### Disadvantages

The theory of anticipated income is not free from demerits. This theory is a method to examine a borrower’s creditworthiness. It gives the bank conditions for examining the potential of a borrower to favorably repay a loan on time. It also fails to meet emergency cash requirements.

**LIQUIDITY PROCEDURE:-** Effective liquidity management requires 3 steps:-

* Identifying liquidity
* Managing liquidity
* Optimizing liquidity

These steps are interdependent, each requiring the successful implementation of the other two to optimally manage liquidity.

**1) Identifying liquidity-** It is the foundation on which the entire liquidity management process depends. It involves understanding the balances and positions of the institution on an enterprise-wide level. Identifying liquidity is primarily a function of data gathering and does not include the actual movement or usage of funds.

**2) Managing liquidity-** It involves using the identified liquidity to support the bank’s revenue generating activities. This may include consolidating funds, managing the release of funds to maximize their use.

3) **Optimizing liquidity-** It is an ongoing process with a focus on maximizing the value of the institution’s fund. It requires strong and detail understanding of bank’s liquidity position across all currencies, accounts, and business lines and counters parties. The biggest challenge in the liquidity management process is the limited and resources available to it.

**Interest Rate Risk Management**

**Meaning**: - It is the chance that an unexpected change in interest rates will negatively affect the value of an investment. A bank main source of profit is converting the liabilities of deposits and borrowings into the assets of loans and securities. It profits by paying a lower interest on its liabilities than it earn on its assets.

**Sources of Interest Rate Risk**

* Re-pricing risk: - This risk arises from holding the assets and liabilities with different principal amounts, maturity, or re-pricing dates, thereby creating exposure to unexpected changes in the interest rates.
* Basis risk embedded option risk- Basis risk arise when interest rate of different assets and liabilities changes in different magnitudes. The basis form of IRR results from the imperfect correlation between interest adjustments when linked to different index rates deposits having the same re-pricing characteristics.
* Yield curve risk- Risk caused due to the change in the yield curve from time to time depending upon re-pricing and various other factors. Yield curve is the relation between the interest rate and the time of maturity of the debt for a given borrower in a given currency.

Effect of interest rate risk
 

**Approaches of IRR:-**

* GAP analysis: - Gap analysis is a tool used by credit unions to analyze the match between rate sensitive assets (RSA) and rate sensitive liabilities (RSL). If RSAs and RSLs are evenly matched the effects of interest rate changes will be minimized while profitability is maximized.
* Simulation model: - Computer generated scenario about future and response to that in a dynamic way. Simulates the performance under alternative interest rate scenarios and assesses the resulting volatility in NII/NIM/ROA/ROE. The purpose of using simulation methods is to test the non-linear effect with many complex rate scenarios and obtain a probabilistic measure of the economic capital to be held against ALM interest-rate risk.
* Rate shift scenarios: - The analysis is used to show the changes in earnings and value expected under different rate scenarios. It attempts to capture the non linear behavior of customers. A common scenario test is to shift all rates up by 1%. After shifting the rates the cash flows are changed according to the behavior expected in the new environment.

UNIT-4

**Topic covered :-**Basel Norms, Capital adequacy, Credit Management, Credit risk, Liquidity.

**Bank Management - Basle Norms**

The foundation of the Basel banking norms is attributed to the incorporation of the Basel Committee on Banking Supervision (BCBS), established by the central bank of theG-10 countries in 1974. This was under the sponsorship of Bank for International Settlements (BIS), Basel, Switzerland.

The Committee forms guidelines and provides recommendations on banking regulation on the basis of capital risk, market risk and operational risk. The Committee was established in response to the chaotic liquidation of Herstatt Bank, based in Cologne, Germany in 1974. The incident demonstrated the existence of settlement risk in international finance.

Later, this committee was renamed as Basel Committee on Banking Supervision. The Committee acts as a forum where regular collaboration concerning banking regulations and supervisory practices between the member countries takes place. The Committee targets at developing supervisory knowhow and the quality of banking supervision quality worldwide.

Presently, there are 27 member countries in the Committee since 2009. These member countries are being represented in the Committee by the central bank and the authority for the prudential supervision of banking business. Apart from banking regulations and supervisory practices, the Committee also stresses on closing the differences in international supervisory coverage.

**Objectives**

* Supervision must be adequate
* No foreign bank should escape supervision

**Basle I**

In 1988, the Basel Committee on Banking Supervision (BCBS) in Basel, Switzerland, announced the first set of minimum capital requirements for banks -Basel I. It completely aimed on credit risk or the default risk. That is the risk of counter party failure. It stated capital need and structure of risk weights for banks.

Under these norms assets of banks were categorized and grouped into five categories according to credit risk, carrying risk weights of 0% like Cash, Bullion, Home Country Debt Like Treasuries, 10, 20, 50 and100% and no rating. Banks with an international presence were expected to hold capital equal to 8% of their risk-weighted assets (RWA). These banks must have at least 4% in Tier I Capital that is Equity Capital + retained earnings and more than 8% in Tier I and Tier II Capital. The target was set to be achieved by 1992.

One of the major functions of Basel norms is to standardize the banking practice across all countries. Anyhow, there are major problems with definition of Capital and Differential Risk Weights to Assets across countries, like Basel standards are computed on the basis of book-value accounting measures of capital, not market values. Accounting practices vary extremely across the G-10 countries and mostly yield outcomes that differ markedly from market assessments.

Another major issue was that the risk weights do not attempt to take account of risks other than credit risks, like market risks, liquidity risks and operational risks that may be critical sources of insolvency exposure for banks.

Unquestionably accepted by developed and developing countries

* Capital requirement 8% of assets
* Tier 1 capital at 4%
* Tier 2 capital at 4%
* Focused on credit risk
* In 1996, the accord was amended to include market risk
* Did not recognize risk exposure according to credibility of borrowers
* No recognition of operational risk

**Basle II**

Basel II was introduced in 2004. It speculated guidelines for capital adequacy that is with more refined definitions, risk management like Market Risk and Operational Risk and exposure needs. It also expressed the use of external ratings agencies to fix the risk weights for corporate, bank and sovereign claims.

Operational risk is defined as “the risk of direct and indirect losses resulting from inadequate or failed internal processes, people and systems or from external events”. This comprises of legal risk, but prohibits strategic and reputation risk. Thereby, legal risk involves exposures to fines, penalties, or punitive damages as a result of supervisory actions in addition to private agreements. There are complex methods to appraise this risk.

The exposure needs permit participants of market to evaluate the capital adequacy of the foundation on the basis of information on the scope of application, capital, risk exposures, risk assessment processes, etc.

Following the South East Asian currency crisis, the Basel Committee met in June 1999 and came up with Basel II.

* Short term funds played a major role in Asian currency crisis.
* Risk weights accordingly adjusted under Basel II.
* Brings order, discipline and safety to banking institutions.
* Involves complex calculations based on huge data.
* Provides a number of approaches for risk measurement.
* Flexibility for banks to choose an approach in line with their risk profile.
* Incentives for stronger and more accurate risk measurement.

**Three Pillars**

* Supervisory review process
* Minimum capital
* Market discipline

**Basle III**

It is believed that the shortcomings of the Basel II norms resulted in the global financial crisis of 2008. That is due to the fact that Basel II norms did not have any explicit regulation on the debt that banks could take on their books, and stressed more on individual financial institutions, while neglecting systemic risks.

To assure that banks don’t take on excessive debt, and that they don’t depend too much on short term funds, Basel III norms were introduced in 2010.The main objective behind these guidelines were to promote a more resilient banking system by stressing on four vital banking parameters — capital, leverage, funding and liquidity.

Needs for mutual equity and Tier 1 capital will be 4.5% and 6%, respectively. The liquidity coverage ratio (LCR) requires the banks to acquire a buffer of high quality liquid assets enough to cope with the cash outflows encountered in an acute short term stress scenario as specified by the supervisors. The minimum LCR need will be to meet 100% on 1 January 2019. This is to secure situations like Bank Run. The term leverage Ratio > 3% denotes that the leverage ratio was calculated by dividing Tier 1 capital by the bank's average total combined assets.

**Capital Adequacy**

Capital adequacy is a ratio that can indicate a bank’s ability to maintain the equity capital sufficient to pay the depositors whenever they demand the money & still have enough funds to increase the bank’s assets through additional lending.

**FEATURES OF CAPITAL ADEQUACY**

* Capital adequacy provides protection to depositors & creditors.
* Capital adequacy relates to the firm’s overall use of financial leverage.
* It measures the relationship between firm’s market value of assets & to ensure the public confidence in trust company system.

**NEED OF CAPITAL ADEQUACY**

* To provide protection to fiduciary accounts.
* To absorb losses not covered by earnings
* To support the growth

The Narasimham committee appointed for framing new economic policy in 1991 endorsed the Basel committee norms for adoption by India banks. Accordingly Reserve Bank of India issued directions for adoption of Basel I norms in 1992. Later Basel II norms have been adapted from March 2008.

At present there is a three-track approach for compiling with Basel norms. Initially all commercial banks should comply with Basel I norms regarding credit and market risk. Urban cooperative banks should maintain capital for credit risk as per Basel I norms and for market risk through surrogate charges.

Rural banks follow capital adequacy norms but these are not on par with Basel norms. Accordingly capital adequacy standards for commercial banks have been determined and implemented.

Reserve Bank of India announced in May 2004 that banks in India should examine the options available under Basel II norms for revised capital adequacy framework and later issued draft guidelines for implementation. These were to be adopted by March 2008. Although all commercial banks are preparing for adoption of revised capital adequacy norms as per Basel II recommendations the complexity and intense data requirements for implementation has brought out several challenges.

Some of the challenges are linking of credit rating with regulatory capital standards, unfavourable effect on credit flows due to inequality in the sovereign ratings of developing and emerging countries compared to developed and industrialized countries.

Differential weights adopted by Reserve Bank of India for non-scheduled banks and financial institutions, extensive data requirements, advanced computational procedure and cost of implementation are the other challenges faced by banks in the implementation of Basel II norms for capital adequacy.

**Disclosure of capital adequacy**

Banks are required to disclose their capital adequacy compliance in a detailed manner indicating compliance for Tier I and Tier II capitals, adjustments made, assumptions of the method adopted and details of capital adequacy for each type of risk coverage namely market risk, operational risk and credit risk. An illustration of capital adequacy compliance is provided below.

**Equity Capital**

* Bank has authorized share capital of XX crores comprising XXXX equity shares of 10/- each.
* Bank has issued, subscribed and paid-up equity capital of XX crores, constituting XXXX number of shares of 10/- each.
* Bank’s shares are listed on the National Stock Exchange and the Bombay Stock Exchange.
* GDRs issued by the bank are listed on the London Stock Exchange (LSE).
* During the year, the Bank has also allotted equity shares to employees under its Employee Stock Option Plan.

**Debt Instruments**

* Bank has raised capital through
* Innovative Perpetual Debt Instrument (IPDI) eligible as Tier 1 Capital
* Tier 2 capital in the form of Upper Tier 2
* Subordinated bonds (unsecured redeemable non-convertible debentures)
* Perpetual Debt Instrument
* The Bank has raised Perpetual Debt Instruments eligible as Tier 1 Capital

**Credit Management**

* Credit management is the process of monitoring and collecting payments from customers. A good credit management system minimizes the amount of capital tied up with debtors.
* It is very important to have good credit management for efficient cash flow. There are instances when a plan seems to be profitable when assumed theoretically but practical execution is not possible due to insufficient funds. In order to avoid such situations, the best alternative is to limit the likelihood of bad debts. This can only be achieved through good credit management practices

**Principles of Credit Management**

Credit management plays a vital role in the banking sector. As we all know bank is one of the major sources of lending capital. So, Banks follow the following principles for lending capital −

1. **Liquidity: -** Liquidity plays a major role when a bank is into lending money. Usually, banks give money for short duration of time. This is because the money they lend is public money. This money can be withdrawn by the depositor at any point of time.
2. **Safety:-**The second most important function of lending is safety, safety of funds lent. Safety means that the borrower should be in a position to repay the loan and interest at regular durations of time without any fail. The repayment of the loan relies on the nature of security and the potential of the borrower to repay the loan**.**
3. **Diversity: -** While selecting an investment portfolio, a commercial bank should abide by the principle of diversity. It should never invest its total funds in a specific type of securities; it should prefer investing in different types of securities.
4. **Stability**: **-** Another essential principle of a bank’s investment policy is stability. A bank should prefer investing in those stocks and securities which hold a high degree of stability in their costs. Any bank cannot incur any loss on the rate of its securities. So it should always invest funds in the shares of branded companies where the probability of decline in their rate is less.
5. **Profitability:-**This should be the chief principle of investment. A bank should only invest if it earns sufficient profits from it. Thus, it should, invest in securities that have a fair and stable return on the funds invested. The procuring capacity of securities and shares relies on the interest rate and the dividend rate and the tax benefits they hold.

**Credit Risk**

**Bank Credit** means the amount of credit available to a company or individual from banking system. It is the aggregate of the amount of funds financial institutions are willing to provide to an individual or organization.

**Credit risk** refers to the risk that a borrower will default on any type of debt by failing to make payments which it is obligated to do.

Credit risk is risk due to uncertainty in a counterparty’s (also called an obligor’s or credit’s) ability to meet its financial obligations The risk is primarily that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs.

Bank operations involve sanctioning of loans and advances to customers for variety of purposes. These loans may be business loans for short or long-term commitments and consumer finance for purchase of durables, property and vehicles. Other types of loans provided by banks are micro credit for small borrowers and contingent obligations that are off balance sheet transactions.

**Loan sanctioning** process commences when the bank receives a loan proposal from the customer. The loan requirement may be for equipment purchase or for working capital finance requirements. If it is for equipment purchase the amount will be paid directly to the supplier. If it is a working capital requirement, an operational bank account in the name of the customer will be opened and permission will be granted to draw the amount as and when required.

**Loan proposal** will be evaluated using an internal rating system or the credit rating offered by external rating agencies. After the loan sanction the bank needs to follow up and monitor the loan accounts. The loan sanctioned may become a default or a bad loan if the outstanding payments (either interest or installment of the principle amount) are overdue by 90 days. Thus credit life cycle involves four stages, credit opportunity, credit assessment, credit management and credit implication.

**Credit worthiness** of the borrowers will influence loan commitment by the bank. The pre-requisites for the loan sanctioned depends on the credit worthiness of the borrower. The requirement of credit worthiness varies depending on type of credit and quantum of loan offered to borrowers.

Besides personal credit worthiness the bankability of the proposal is to be evaluated in terms of projected cash flows, projected investment and past performance of the borrower. Risk exposure for banks is computed considering three factors. The criteria are the default percentage, exposure value for the bank and the estimated recovery rate.

Loss on default = D x E x (1-R)

Where D is default percentage, E is exposure value and R is recovery rate.

**Computation of Credit risk**

Credit risk is inherent in the bank lending process. Therefore banks have to meticulously plan, understand and apply risk measures. All personnel and departments involved in credit management must have a thorough understanding of credit risk. Banks follow systematic methods of risk computation and apply them for loan decisions. They develop and organize credit information for this purpose.

The internal rating system followed by banks requires both financial as well as qualitative information on the project and the borrower. Certain key ratios and cash flow projections are the basis for the quantitative measurement of risk. The risk measures computed by banks could be a one ‐time measure for a borrower or a measure that is monitored throughout the loan servicing period. These methods are known as point‐in‐time measure and life‐cycle measure. Any method or model adopted by the bank needs to be evaluated as to its reliability. Usually past borrower data will be used to examine the reliability of models developed for credit risk analysis.

By constant review and updating of the error probability of these models that banks will be able to reduce risk substantially and make them desirable for application. Besides internal rating system banks also depend on information provided by rating agencies. Based on credit analysis the loan proposals will be rated and graded. These ratings and grades may undergo change on account of new developments or changes affecting the business of the borrower.

Accordingly the probability of default and the probability of loss will have to be kept flexible and needs review periodically.

**Credit Risk Management**

For effective credit risk management, banks have to establish an integrated credit risk management system. In this executives at Board level as well as bank staffs dealing in credit risk at branch level are to be involved. Proper procedures, documentation, methods of appraisal and credit audit are to be incorporated in the system.

Credit risk involves probability of loss of loan sanctioned. This loss comprises nonpayment of interest or principle, counter party obligations not met, settlement claims not met, default on account of restrictions imposed, foreign exchange remittances and inability of the borrower to meet contingent expenditures.

Credit risk is affected by bank specific internal factors or external factors such as changes in the economy. Internal risk factors can be managed by adopting a systematic credit risk management policy and procedure. Managing external factors involves diversification of credit among different industry groups and different borrowers.

Prudential norms for credit risk management calls for a comprehensive policy framework laying down strategies, organizational structure, system support, credit risk rating framework, credit risk limits, credit risk modeling, credit risk pricing, risk mitigation, low review mechanism and credit audit.

Banks have several choices regarding the model for credit risk computation. Certain popular models in use are Altman’s model, credit metrics model, value at risk model and KMV model. Depending on the suitability and the requirements of banks a model can be chosen and adopted for credit risk measurement.

The main aim of credit risk management is not only quantifying risk but also reducing exposure of credit risk by adopting safety measures through collateral securities, guarantees, credit derivatives and balance sheet netting.

RBI guidelines on credit exposure and management call for adoption of prudential norms. This specifies both quantitative and qualitative restrictions on loan sanctions.

**LIQUIDITY**

Ability to meet anticipated and contingent cash needs. Cash needs may arise from withdrawal of deposits, liability maturities' and loan disbursals. A minimum criterion of liquidity is the ability both to meet commitments when due and to undertake new transactions when desirable.

**Estimating liquidity needs**

* Banks strive to maintain adequate liquidity- too much liquidity needlessly limits bank earnings, and too little liquidity exposes a bank to the possibility of costly emergency measures to secure needed funds.
* Liquidity should be sufficient to cover probable fluctuations in loans and deposits, with a small margin of excess liquidity as a safety measure.
* If a bank has carefully evaluated and planned for its liquidity needs, it should hold a maximum liquidity when deposits are up and loan demand is down.

**Liquidity risk: - There are three types of liquidity risks:-**

* + - 1. **Funding Risk: -** It depends on the perception of the market of the credit standing of the bank. A bank approaching the market with unexpected and frequent needs for funds would have adverse affect on the willingness of the market to lend and raises the cost of funds which is the prime driver of profitability.
      2. **Asset Liquidity Risk: -** It arises when assets are not readily tradable. The rationale of liquidity ratio is to make banks hold more short-term assets than short-term liabilities. Liquidity risk arises when maturities of assets exceed those of liabilities.
      3. **Interest Rate Risk: -** Liquidity risk is closely related to interest rate risk. If a bank desires to have more interest sensitive liabilities than assets it reduces the liquidity position of banks. When a bank structure its portfolio in order to achieve a positive duration gap (assets>liabilities), the liquidity of the assets is reduced. If interest rate increases the value of long-duration assets will decline more than short-duration assets and assets sales would involve losses.

**MANAGEMENT OF LIQUIDITY**

* In the context of increased competition and decreased profit margins, the need to improve efficiency of operation through competent liquidity management has become imperative.
* Liquidity management consists of estimating the requirements for funds and meeting them. Funds requirement depends upon deposit inflows and outflows and loan commitments.
* A bank should devise a liquidity plan or strategy that balances risks and returns.
* Liquidity needs arising from deposits withdrawals and loan demands can be estimated by preparing a sources and uses of funds statements.
* The sources and uses approachcan be used to evaluate the effects of deposit inflows and outflows and changing loan demands on bank liquidity.
* The structure of deposits method consisting of a list of different types of deposit and the probability is another way to estimate liquidity needs.

**INSTRUMENTS OF LIQUIDITY**

Banks traditionally have planned for liquidity through their asset portfolios, constructing them so that some assets can and will be liquidated as funds are needed. More recently bankers have found that they can also secure needed liquidity by increasing their liabilities. Thus, bankers have 2 sources of managing liquidity:

* + - * 1. Liquid assets
        2. Liquid liabilities

**Liquid assets:-**

* Cash in hand-This includes the cash balance maintained by a bank with itself. The quantum of such cash balance depends upon the experience and circumstances of each individual bank and no hard and fast rules can be laid down.
* Statutory Liquidity Ratio- Statutory Liquidity Ratio refers to the amount that the commercial banks require to maintain in the form of cash or gold or govt. approved securities before providing credit to the customers. It is determined as percentage of total demand and percentage of time liabilities.
* Balances with other banks- The cash balances maintained by banks either with themselves or in current accounts with the RBI are the most liquid assets and therefore, they can rightly be termed as the first line of defense in times of trouble.
* Money at call and short notice- These loans represents mainly the loans given by one bank to another for a short period.
* Investments- The banks also invest a significant portion of their funds in stock exchange securities. These constitute the third line of defensein times of emergencies. These securities mainly include:
* Government securities-They may be of 3 types
  + 1. Stocks b) Bearer bonds c) Promissory notes
* Semi-government securities- These includes debentures or bonds issued by quasi- government organizations like improvement Trusts, Municipal Corporations.
* Shares and Debentures of joint companies- It is done by commercial banks on a very marginal scale because of uncertainty both regarding return as well as value.
  + 1. **Liquid Liabilities:**
* Time Certificates of Deposits**-** They are negotiable and can be sold by the holder in the market. These certificates bear different maturities ranging from ninety days to one year and are offers with the interest rates competitive with treasury bills and other similar money market instruments.
* Borrowing from other commercial banks**-** The second way in which the individual commercial bank may create additional liabilities in order to acquire reserves is by borrowing from other banks. Such loans are given on a one-day, unsecured basis. Rate on bank loans is very sensitive to changing trends of supply and demand in the money market.
* Borrowing from Central Bank**-** Central bank facilities are available generally in the form of discounting or advance to meet day-to-day and seasonal liquidity needs of commercial banks registered with the central bank. Normally such loans are relatively costlier and are available at restrictive terms.
* Raising of Capital Funds- Commercial banks can acquire reserves by issue of shares carrying different features to suit varying notions of investors. Availability of funds through this source would depend on public response to bank shares which in its turn is essential conditioned by current dividend rate and growth prospect associated with it.

**Liquidity Management Theory/ Approaches**

* + - 1. **Commercial Loan Theory: -** The commercial loan or the real bills doctrine theory states that a commercial bank should forward only short-term self-liquidating productive loans to business organizations. Loans meant to finance the production, and evolution of goods through the successive phases of production, storage, transportation, and distribution are considered as self-liquidating loans.

This theory also states that whenever commercial banks make short term self-liquidating productive loans, the central bank should lend to the banks on the security of such short-term loans. This principle assures that the appropriate degree of liquidity for each bank and appropriate money supply for the whole economy.

The central bank was expected to increase or erase bank reserves by rediscounting approved loans. When business started growing and the requirements of trade increased, banks were able to capture additional reserves by rediscounting bills with the central banks. When business went down and the requirements of trade declined, the volume of rediscounting of bills would fall, the supply of bank reserves and the amount of bank credit and money would also contract.

### Advantages

These short-term self-liquidating productive loans acquire three advantages. First, they acquire liquidity so they automatically liquidate themselves. Second, as they mature in the short run and are for productive ambitions, there is no risk of their running to bad debts. Third, such loans are high on productivity and earn income for the banks.

### Disadvantages

Despite the advantages, the commercial loan theory has certain defects. First, if a bank declines to grant loan until the old loan is repaid, the disheartened borrower will have to minimize production which will ultimately affect business activity. If all the banks pursue the same rule, this may result in reduction in the money supply and cost in the community. As a result, it makes it impossible for existing debtors to repay their loans in time.

Second, this theory believes that loans are self-liquidating under normal economic circumstances. If there is depression, production and trade deteriorate and the debtor fails to repay the debt at maturity.

Third, this theory disregards the fact that the liquidity of a bank relies on the salability of its liquid assets and not on real trade bills. It assures safety, liquidity and profitability. The bank need not depend on maturities in time of trouble.

Fourth, the general demerit of this theory is that no loan is self-liquidating. A loan given to a retailer is not self-liquidating if the items purchased are not sold to consumers and stay with the retailer. In simple words a loan to be successful engages a third party. In this case the consumers are the third party, besides the lender and the borrower.

## Shiftability Theory:- This theory was proposed by H.G. Moulton who insisted that if the commercial banks continue a substantial amount of assets that can be moved to other banks for cash without any loss of material. In case of requirement, there is no need to depend on maturities.

This theory states that, for an asset to be perfectly shiftable, it must be directly transferable without any loss of capital loss when there is a need for liquidity. This is specifically used for short term market investments, like treasury bills and bills of exchange which can be directly sold whenever there is a need to raise funds by banks.

But in general circumstances when all banks require liquidity, the shiftability theory need all banks to acquire such assets which can be shifted on to the central bank which is the lender of the last resort.

### Advantage

The shiftability theory has positive elements of truth. Now banks obtain sound assets which can be shifted on to other banks. Shares and debentures of large enterprises are welcomed as liquid assets accompanied by treasury bills and bills of exchange. This has motivated term lending by banks.

**Disadvantage**

Shiftability theory has its own demerits. Firstly, only shiftability of assets does not provide liquidity to the banking system. It completely relies on the economic conditions. Secondly, this theory neglects acute depression, the shares and debentures cannot be shifted to others by the banks. In such a situation, there are no buyers and all who possess them want to sell them. Third, a single bank may have shiftable assets in sufficient quantities but if it tries to sell them when there is a run on the bank, it may adversely affect the entire banking system. Fourth, if all the banks simultaneously start shifting their assets, it would have disastrous effects on both the lenders and the borrowers.

## Anticipated Income Theory:- This theory was proposed by H.V. Prochanow in 1944 on the basis of the practice of extending term loans by the US commercial banks. This theory states that irrespective of the nature and feature of a borrower’s business, the bank plans the liquidation of the term-loan from the expected income of the borrower. A term-loan is for a period exceeding one year and extending to a period less than five years.

It is admitted against the hypothecation (pledge as security) of machinery, stock and even immovable property. The bank puts limitations on the financial activities of the borrower while lending this loan. While lending a loan, the bank considers security along with the anticipated earnings of the borrower. So a loan by the bank gets repaid by the future earnings of the borrower in installments, rather giving a lump sum at the maturity of the loan.

### Advantages

This theory dominates the commercial loan theory and the shiftability theory as it satisfies the three major objectives of liquidity, safety and profitability. Liquidity is settled to the bank when the borrower saves and repays the loan regularly after certain period of time in installments. It fulfills the safety principle as the bank permits a relying on good security as well as the ability of the borrower to repay the loan. The bank can use its excess reserves in lending term-loan and is convinced of a regular income. Lastly, the term-loan is highly profitable for the business community which collects funds for medium-terms.

**Disadvantages**:-The theory of anticipated income is not free from demerits. This theory is a method to examine a borrower’s creditworthiness. It gives the bank conditions for examining the potential of a borrower to favorably repay a loan on time. It also fails to meet emergency cash requirements.

**LIQUIDITY PROCEDURE:-** Effective liquidity management requires 3 steps:-

* Identifying liquidity
* Managing liquidity
* Optimizing liquidity

These steps are interdependent, each requiring the successful implementation of the other two to optimally manage liquidity.

**1) Identifying liquidity-** It is the foundation on which the entire liquidity management process depends. It involves understanding the balances and positions of the institution on an enterprise-wide level. Identifying liquidity is primarily a function of data gathering and does not include the actual movement or usage of funds.

**2) Managing liquidity-** It involves using the identified liquidity to support the bank’s revenue generating activities. This may include consolidating funds, managing the release of funds to maximize their use.

3) **Optimizing liquidity-** It is an ongoing process with a focus on maximizing the value of the institution’s fund. It requires strong and detail understanding of bank’s liquidity position across all currencies, accounts, and business lines and counters parties. The biggest challenge in the liquidity management process is the limited and resources available to it.

**Thank you**