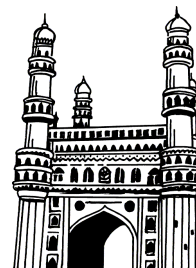


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UNIT I

Introduction :

Functions of Commercial Banks - Emerging Trends in Commercial Banking in India: E-Banking - Mobile Banking - Core Banking - Bank Assurance - OMBUDSMAN. RBI Constitution - Organizational Structure - Management - Objectives - Functions - Monetary Policy - Brief description on various types of banks - District Co-Operative Central Banks - Contemporary Banks - Regional Rural Banks - National Bank for Agriculture and Rural Development (NABARD) - SIDBI - Development Banks

1.1 INTRODUCTION TO BANKING

Q1. Define the term bank. Explain the features of banks.

Ans :

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 of a Bank

- (i) **According to Oxford Dictionary** defines a bank as “an establishment for custody of money, which it pays out on customer's order.”
- (ii) **According to Section 5(1) (b) of the Banking Regulation Act, 1949** defines **banking** as, “The accepting for the purpose of lending or investment, of deposits from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise”.
- (iii) **According to Section 5(1) (c) defines a banking company** as, “Any company which transacts the business of banking in India”.

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.

Q2. What are the Functions of Banks?

Ans :

Banks are both manufactures of money and purveyors of money. So banks play an important role in the economy. Their functions can be set out under the following heads :

1. Mobilization of Savings

Economic development depends on the available savings and investment in the economy. By mobilization of deposits, banks collect savings from the public which in turn are lent for investment when they purvey credit to various sectors of the economy.

2. Facilitate Commerce and Trade

Finance is important for trade and commerce and banks which provide funds for facilitating these types of activities in the economy.

3. Balanced Regional Development

In tune with the policy of the government to have more balanced development of the economy, the banks do promote lending and investment in those regions or parts of the country which are less developed and thus banks promote social objectives.

4. Provision of Finance to Backward Communities and Neglected Segments of Society

This is another important contribution of commercial and co-operative banks in India. They provide loans at concessional rates to scheduled castes/scheduled tribes and weaker sections of the society, as per the guidelines of the government.

5. Development of Agriculture and other Priority Sectors in the Economy

The banks give special treatment in their lending operations to some priority sectors in the economy, such as agriculture, small- scale

industries (SSIs), retail trade, small borrowers, self-employed persons, etc., so as to facilitate their growth and provide productive employment in the economy. Exports are also a priority sector which banks help in various ways.

Q3. Explain evolution of banking in India.

Ans :

The banking history is interesting and reflects evolution in trade and commerce.

- It also throws light on living %style, political and cultural aspects of civilized mankind. The strongest faith of people has always been religion and God.
- The seat of religion and place of worship were considered safe place for money and valuables.
- Ancient homes didn't have the benefit of a steel safe, therefore, most wealthy people held accounts at their temples.
- Numerous people, like priests or temple workers were both devout and honest, always occupied the temples, adding a sense of security.

Origin of Banks

The modern banking system in India started with the establishment of General Bank of India in 1786.

- In the mid-nineteenth century the East India Company established the Bank of Bengal in 1809, the Bank of Bombay in 1840 and the Bank of Madras in 1843.
- These were initially independent units and were referred to as the Presidency banks.
- Subsequently, these three banks were amalgamated and became known as the Imperial Bank of India. After independence the Imperial Bank of India (which till then functioned as a private bank) was nationalized under the State Bank of India Act of 1955 and became known as the State Bank of India.
- Nationalization was a major theme during the period after independence due to the socialist philosophy adopted by the first Prime Minister, Jawaharlal Nehru.

- In 1969 Indira Gandhi, the Prime minister, continued this process by nationalizing 14 major banks.
- Indian banks are unique in many respects. Prior to 1991 all banks were state owned. In 1991 when the government opened banking to private banks (e.g., ICICI bank and Bank of America), the public sector has dropped by 20%.
- However, state owned banks still controls approximately 80% of the country's banking assets. The key chronological events of banks in India are shown in table.

Date	Key Event
1949	The Reserve Bank of India (RBI) is nationalized and made a central bank by an act of parliament.
1956	Nationalization continues. All Life Insurance Companies now nationalized.
1969	Nationalization completed. Fourteen major banks nationalized by Mrs. Indira Gandhi. Now all banks are state owned.
1980	Nationalization of six banks.
1992	Dual exchange rate system is instituted under liberalized rate. Now exchange rate moves from managed floated regime to a market determined one. Expected to provide boost to export industry.
1993	RBI introduces Risk-Assets-Ratio for banks as a capital adequacy measure.
1993	Guidelines for setting-up private sector banks are issued.
1993	Process of convertibility is started and rupee is made convertible on current account. Expected to provide a stimulus to business and hence should provide an impetus to banks as well.
1994	UTI becomes the first private bank to start operation.
1994	RBI issued guidelines on prudential norms. Banks should achieve minimum capital adequacy ratio is set at 6% on their risk weighted assets and off balance sheet exposures; to be maintained by March 31, 1995.
1994	Amendment to Banking Companies Act. Enabled all state owned banks to tap the capital market. The nationalized banks can now strengthen their capital base by issuing stock.
1994	Full convertibility taken by making the rupee convertible on the current account.
1994	Oriental bank of Commerce becomes the first state owned bank to raise a significant amount of money by issuing stock in the stock market (₹387.2 crore).
2003	New law enacted by parliament. Enables banks to sue customers when they default on payments to obtain payment. Stock prices of state owned banks surge. State owned bank capitalization now greater than InfoTech company's capitalization.

The Indian government has a tradition of using state owned banks to rescue failing institutions or to funnel money to favoured projects which has little chance of paying-off the loan. Further, a study by McKinsey and Co., consultants finds that the productivity of Indian banks is only one-tenth on the productivity of U.S. banks. In general, India's banking system is so dysfunctional that it is slowing the economy.

Nationalization of Banks

The year 1949 marked the beginning of a new era in the economic history of India. It was the beginning of a period of remedy and a period of seed time. As soon as India became independent the government embarked upon a programme of removing the ills of the past and sowing the seeds of economic independence, economic growth and economic prosperity.

Objectives of Nationalization

The nationalization of commercial banks took place with an aim to achieve following major objectives;

1) Social Welfare

It was the need of the hour to direct the funds for the needy and required sectors of the Indian economy. Sectors such as agriculture, small, and village industries were in need of funds for their expansion and further economic development.

2) Controlling Private Monopolies

Prior to nationalization many banks were controlled by private business houses and corporate families. It was necessary to check these monopolies in order to ensure a smooth supply of credit to socially desirable sections.

3) Expansion of Banking

In a large country like India the numbers of banks existing those days were certainly inadequate. It was necessary to spread banking across the country. It could be done through expanding banking network (by opening new bank branches) in the unbanked areas.

4) Reducing Regional Imbalance

In a country like India where we have an urban-rural divide; it was necessary for banks to go in the rural areas where the banking facilities were not available. In order to reduce this regional imbalance nationalization was justified.

5) Priority Sector Lending

In India, the agriculture sector and its allied activities were the largest contributor to the national income. Thus these were labelled as the priority sectors. But unfortunately they were deprived of their due share in the credit. Nationalization was urgently needed for catering funds to them.

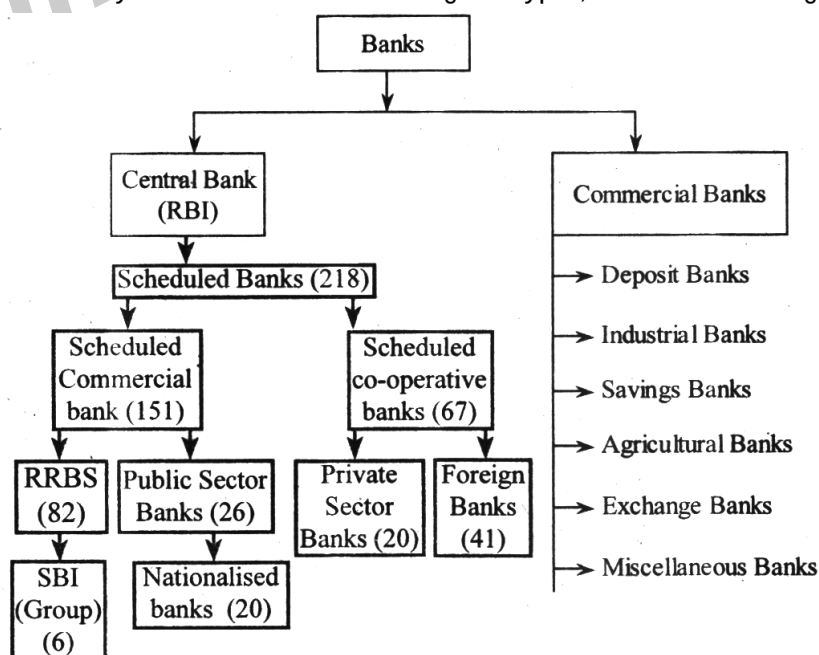
6) Developing Banking Habits

In India more than 70% population used to stay in rural areas. It was necessary to develop the banking habit among such a large population.

Q4. Classify the different types of banks.

Ans :

Banks can be broadly classified into the following two types, as shown in the figure:



(A) Central Bank

Central bank is an autonomous institution which holds immense powers and control over the entire banking system of the country. In India the Reserve Bank of India (RBI) is the central bank of the country. According to R.R Kent "Central bank is the institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare".

Reserve bank of India Act, 1934 comprises scheduled commercial banks in its second schedule. Scheduled commercial banks are further divided into four categories,

1. Public sector banks
2. Private sector banks
3. Foreign banks in India and
4. Regional rural banks.

There are 81 scheduled commercial banks out of which 26 constitutes the public sector banks, 21 are reserved for private sector banks whereas the remaining 34 belongs to foreign banks.

1. Public Sector Banks

Government has the chief authority in public sector banks. Public sector banks broadly classified into two categories,

- (a) State bank of India and its associates and
- (b) Nationalised banks.

(a) State Bank of India

The state bank of India was introduced on July 1, 1955. The five subsidiaries under the state bank of India includes the State Bank of Bikaner and Jaipur, the State Bank of Hyderabad, the State Bank of Mysore, the State Bank of Patiala and, the State Bank of Travancore.

The state bank of India is the largest commercial bank, in the world with an aggregate of nearly 16055 branches comprising 4607 branches of its associate bank, 131 foreign offices in 32 countries and 2410 ATMs networked with SBI ATMs in India. SBI holds a total of 17% market share

with an asset base of about ₹ 542503 crore. It is considered as the country's largest bank wherein there exists 100 million accounts with a total workforce of about 2,14,845.

SBI has funded 17 RRBs till March 31, 2009. SBI has five non-banking subsidiaries,

The current plan of SBI is to make itself as "Universal bank" which helps in meeting the different needs of the society through reformation of its branches into 'super shoppe' wherein its products such as banking, insurance, mutual funds and credit cards would be sold.

(b) Nationalised Banks

Banks are nationalised under the banking companies Act, 1970. This phase of nationalisation constitutes the second stage of nationalisation. In 1969, nearly fourteen big Indian joint stock banks belonging to the private sector undergone the nationalisation process. During the third stage of nationalisation, six commercial banks in the private sector with an average deposits of over ₹ 200 crores were nationalised on August 15, 1980. Presently, there are 27 nationalised Banks, the state bank of India and its six associates and 19 nationalized banks and IDBI. The main objective for nationalisation was to provide financial assistance by network to the rural and semi urban areas.

From there onwards, the Nationalisation of banks commenced. The objectives of Nationalised banks were,

- (i) To provide major banking facilities exclusively to the rural and semi-urban areas.
- (ii) To spread awareness of agricultural finance and to overcome the causes for the downfalls of the agricultural finance system.
- (iii) To facilitate the reserve bank in the formulation of its credit policies.
- (iv) To provide assistance to the government in carrying out the broad economic policies.

2. Private Sector Banks

The Narasimham committee, stated in its report that the RBI should allow the establishment of new banks if they are capable of fulfilling the minimum start-up capital and other requirements. And also stated that there should be no discrimination between the public sector and private sector. The banks established after the committee report are known as new private sector banks.

In a recent scenario there exists 21 private sector banks out of which 14 banks are old whereas, the remaining banks are new banks. New banks generated profits from the first year itself. The public sector banks are facing heavy competition from the private sector banks.

In January 2001, the guidelines relating to the establishment of new private sector were updated or revised.

- (a) It recommended to raise initial minimum paid-up capital from ` 100 crore to ` 200 crore. Further, the initial minimum paid up capital shall be increased to ` 300 crore in the next three consecutive after the establishment of a business enterprise.
- (b) It allowed a Non-Banking Finance Company (NBFC) to transform into a commercial bank if it satisfies the following conditions,
 - (i) Establishes with a total minimum net worth of ` 200 crore.
 - (ii) Holds a credit rating of 'AAA' or its equivalent ratings in the previous year.
 - (iii) Sufficient capital of less than 12 percent and
 - (iv) Net NPAs whose worth should not be more than 5 percent.
- (c) The guidelines restrict the huge industrial houses to advertise any new bank. The individual firms associated directly or indirectly with large industrial houses are only allowed to contribute a maximum of 10% in the total equity of a new private sector bank.
- (d) The option would be provided to those promoters who are having expertise in financing the priority areas and also in

establishing banks which are specialised in financing the operations of rural agro-based industries.

3. Foreign Banks in India

A survey conducted identifying the number of foreign banks in India on April 30, 2010. A total of 34 foreign banks have been identified in India with 311 branches. Furthermore, 45 foreign banks are operating in India by establishing their representative offices. The standard chartered bank consists of the highest number of branches (i.e., 92) among all foreign banks in India.

Some foreign banks have been operating in India over the hundred years. For instance ANZ Grindlays and standard chartered banks have been operating in India for more than a decade. Few foreign banks have established various entities that are operating in India as subsidiaries constituting either the non-banking financing companies or limited companies in the non-financial sector which comprise different businesses like dealing in securities, leasing and finance, information and technology.

Examples : HSBC, Bank of America and so on.

The RBI guidelines for foreign banks in India,

- (a) In the first stage, from March 2005 to 2009, the eligible foreign banks were allowed to establish their presence by initiating a wholly-owned banking subsidiary or by converting the existing branches into a subsidiary.
- (b) For making the presence, the wholly-owned banking subsidiary is required to have a minimum capital of ` 300 crore and a strong corporate governance for its operations.
- (c) In the second stage in April 2009, the new foreign banks were permitted to operate in India if the banks were found to be financially sound wherein they consider the international and home country ranking, rating, international presence and economic and political relations between the two countries.
- (d) The minimum capital stipulated is USD 25 million has to be divided among 3 branches where the first two branches get a capital of about USD 10 million while the remaining

amount of USD 5 million must be allocated to the third branch. More branches are allowed after observing the operations of present branches. 12 licenses are determined in compliance with India's commitment made to WTO, per annum for new and for expanding the existing banks.

- (e) Foreign banks are required to lend an aggregate of about 32% of their adjusted net bank credit or credit equal to the off-balance sheet exposures, whichever is found to be more.

4. Regional Rural Banks

The main purpose of regional rural banks was to deliver the rural credit facilities to the backward areas thereby, ensuring their financial soundness. Central government, respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of regional rural banks (RRB's) has been proposed by the Reserve Bank of India (RBI) and NABARD.

Examples

Andhra Pradesh Grameena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujarat Bank, Himachal Gramin Bank etc.

(B) Commercial Bank

Commercial Banks are business enterprises which are involved in finances, financial instruments and provide financial services for a price which may be in the form of interest, commission or a discount and so on. "They accept deposits of money from the public (savings), for the purpose of lending or investment (to meet working capital requirements or corporates)" - Banking regulation act 1949 banks are categorized into,

Public sector	Example	: SBI, Andhra Bank
Private sector	Example	: Milli Bank
Foreign sector	Example	: HSBC, HDFC.

The different types of commercial banks are as follows:

(a) Deposits Banks

It is one of the type of commercial bank which deals with short term deposit and loans.

Deposit banks accept deposits from the public and lend money to the customers who are in need of loans. Deposit banks extend loans for a short period ranging from 3 to 6 months.

(b) Industrial Banks

Industrial banks extend long term loans to the industries which require huge capital for buying heavy machineries and equipments. Moreover, they also deal with the process of buying shares and debentures of companies which would help the companies to hold fixed capital. Industrial banks perform the following functions.

- Accepting long-term deposits.
- Extending long-term loans to the industries for fulfilling their credit needs.
- Helps the companies in dealing with the purchase and sales of shares and debentures.

(c) Savings Banks

Savings banks are basically started with an aim to encourage the small savers like, poor or middle class customers to save their money in the form of deposits in these banks. However, in India due to absence of such banks, post offices perform the function of savings banks.

(d) Agricultural Banks

Agricultural banks are of two types:

- Agricultural co-operative banks and
- Land mortgage banks and co-operative bank.

Agricultural banks are established to help the farmers by providing short, medium or long-term loans.

(e) Exchange Banks

Exchange banks are the commercial banks which exclusively deal with the foreign trade such as, discounting, accepting and collecting foreign bills of exchange. They perform the functions of buying and selling foreign

currency. These banks also provide services like that of the other ordinary banks.

(f) Miscellaneous Banks

Miscellaneous banks are special kind of commercial banks which are established to meet the specialized needs of the customers. For instance - Investments banks in England and America are formed with an objective to control the distribution of capital into several uses.

1.2 FUNCTIONS OF COMMERCIAL BANKS

Q5. Explain in detail about Commercial Banks.

Ans :

Commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation, and agency functions. They are also called joint stock banks because they are organized in the same manner as joint stock companies. They usually advance short-term loans to customers. Now, they have started giving medium-term and long-term loans also. In India 20 major commercial banks have been nationalized, whereas in developed countries they are run like joint stock companies in the private sector. Some of the commercial banks in India are Andhra Bank, Canara Bank, Indian Bank, Punjab National Bank, etc.

Definition

- (i) According to Crowther,** "A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it".
- (ii) According to Prof. Sayers,** "An institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other".
- (iii) According to Prof. Kinley,** "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use".
- (iv) Indian Companies Act, 1949,** has defined the bank, "The accepting for the purpose of lending or investment of deposits of money

from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise".

The commercial banks generally extend short-term loans to businessmen and traders. Since their deposits are for a short period only, they cannot lend money for a long period. Ordinarily, these banks extend loans for a period between 3 to 6 months. These banks are not in a position to grant long-term loans to industries because their deposits are only for a short period.

Commercial banks are categorised as,

- (a) Public sector banks
- (b) Private sector banks
- (c) Foreign banks
- (d) Regional rural banks.

(a) Public Sector Banks

In India, public sector banks are regulated by the various laws and statutes proposed by the parliament. The board of public sector banks comprises directors in the form of chairman, managing director government nominee director, RBI's nominee director and some other elected directors and so on. Till the end of March 2009, the number of public sector banks in India were numbered to 20. (out of which 20 were nationalised banks was State Bank of India (SBI) and 6 were associates banks of SBI).

Example :

State bank of India (SBI), Central Bank of India, Andhra Bank, Bank of Baroda, Punjab National Bank etc.

(b) Private Sector Banks

In March 2009 the number of private sector banks in India were found to be 22. Among them, 15 constituted the old banks while the remaining 7 were new private sector banks. The main purpose behind the allowance of private sector to own and operate banks was to ensure the diversification of ownership and control. New private sector banks are also permitted to enter the market with an initial capital of about ₹. 200 crores, which would increase to a total of about ₹. 300 crores in the next three consecutive years. In India for any private sector bank, the aggregate foreign investment is restricted

to only 76% of the paid up capital, (i.e., the remaining capital must be contributed by the residents of a country.

Examples

Global Trust Bank Ltd., ICICI Banking Corporation Bank Ltd., Axis Bank, HDFC etc.

(c) Foreign Banks

In India, foreign banks can operate through any one of the following options,

- (i) They can operate through the establishment of their own branches (may be in same country or in some other country).
- (ii) They can also enter the market by establishment of the wholly owned subsidiaries.
- (iii) They can also establish the partly owned subsidiaries with an maximum aggregate investment of about 74 percent (in any private sector bank).

Any foreign bank on establishing its first branch in India is required to invest an initial capital of about 25 million U.S dollars. In March 2009, the number of foreign banks in India were found to be only 32.

Examples

Bank of Tokyo Ltd., Citi Bank N.C, Standard Chartered Bank Ltd., American Express Bank etc.

(d) Regional Rural Banks

There were only 84 Regional Rural Banks in India by the end of March 2009. The main purpose of regional rural banks was to at deliver the rural credit facilities to the backward areas. Thereby, ensuring their financial soundness. Central government respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of regional rural banks (RRB's) has been proposed by the Reserve Banks of India (RBI) and NABARD which helps in supervising their operations with some supervisory powers.

Examples

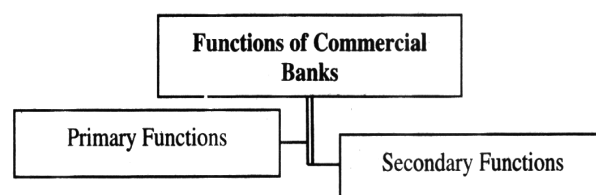
Andhra Pradesh Grameena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujrat Bank, Himachal Gramin Bank etc.

Q6. What are the various functions of commercial banks?

Ans :

Functions of Commercial Banks

Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories:



1. Primary Functions

Primary banking functions of the commercial banks include the following:

i) Acceptance of Deposits

It is the primary function of a commercial bank mobilise savings of the household sector. Banks generally accept three types of deposits, viz.:

- a) **Current Deposits:** These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make large payments through banks. The bank levies certain incidental charges on the customer for the services rendered by it.
- b) **Savings Deposits:** This is meant mainly for professional men and middle class people to help them deposit their small savings. It can be opened without any introduction. Money can be deposited at any time but the maximum

cannot go beyond a certain limit. There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. The rate of interest is greater than the rate of interest on the current deposits and less than that on fixed deposit. This system greatly encourages the habit of thrift or savings.

- c) **Fixed Deposits:** These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest. In India, they are accepted between three months and ten years.

ii) Advancing Loans

The second primary function of commercial banks is to make loans and advances to all type of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common way of lending is by:

- a) **Overdraft Facilities:** In this case, the depositor in a current account is allowed to draw over and above his account upto a previously agreed limit. **For example,** a businessman has only ₹ 30,000 in his current account in a bank but requires ₹ 60,000 to meet his expenses. He may approach his bank and borrow the additional amount of ₹ 30,000. The bank allows the customer to overdraw his account through

cheques. The bank, however, charges interest only on the amount overdrawn from the account. This type of loan is very popular with the Indian businessmen.

- b) **Cash Credit:** Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the amount of credit availed to him. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him. Besides, the bank can also give specified loan to a person, for a firm against some collateral security. The bank can recall such loans at its option.

- c) **Discounting Bills of Exchange:** This is another type of lending which is very popular with the modern banks. The holder of a bill can get it discounted by the bank, when he is in need of money. After deducting its commission, the bank pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide a very liquid asset which can be quickly turned into cash. The commercial banks can re-discount the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

- d) **Money at Call:** Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers, usually dealers or brokers in stock exchange markets against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence, they are described as money at call or call money.

e) **Term Loans:** Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans, as such provide intermediate or working capital funds to the borrowers. Sometimes, two or more banks may jointly provide long-term loans to the borrower against a common security. Such loans are called participation loans or consortium finance.

f) **Consumer Credit:** Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc. Such consumer credit is made in a lumpsum and is repayable in instalments in a short time. Under the 20-point programme, the scope of consumer credit has been extended to cover expenses on marriage, funeral, etc., as well.

g) **Miscellaneous Advances:** Among other forms of bank advances there are packing credits given to exporters for a short duration, export bills purchased/discounted, import finance-advances against import bills, finance to the self-employed, credit to the public sector, credit to the cooperative sector and above all, credit to the weaker sections of the community at concessional rates.

iii) Creation of Credit

A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money. Bank deposits are regarded as money. They are as good as cash. The reason is they can be used for the purchase of goods and services and also in payment of debts. When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a

deposit without receiving cash. That is, banks are said to have created credit.

iv) Promote the Use of Cheques

The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash. The cheque is the most developed type of credit instalment in the money market.

v) Financing Internal and Foreign Trade

The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.

vi) Remittance of Funds

Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges. As compared to the postal money orders or other instruments, bank drafts have proved to be a much cheaper mode of transferring money and have helped the business community considerably.

2. Secondary Functions: Secondary banking functions of the commercial banks include the following:

i) Agency Services

Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large.

The various agency services rendered by banks are as follows:

- a) Collection and Payment of Credit Instruments:** Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes, etc., on behalf of their customers.
- b) Purchase and Sale of Securities:** Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.
- c) Collection of Dividends on Shares:** Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.
- d) Acts as Correspondent:** Sometimes banks act as representative and correspondents of their customers. They get passports, traveller's tickets and even secure air and sea passages for their customers.
- e) Income Tax Consultancy:** Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.
- f) Execution of Standing Orders:** Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia, etc., on behalf of their customers.
- g) Acts as Trustee and Executor:** Banks preserve the 'Wills' of their customers and execute them after their death.
- ii) General Utility Services**
- In addition to agency services, the modern banks provide many general utility services for the community as given:
- (a) Locker Facility:** Bank provides locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.
- b) Traveller's Cheques and Credit Cards:** Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.
- c) Letter of Credit:** These are issued by the banks to their customers certifying their creditworthiness. Letters of credit are very useful in foreign trade.
- d) Collection of Statistics:** Banks collect statistics giving important information relating to trade, commerce, industries, money and banking. They also publish valuable journals and bulletins containing articles on economic and financial matters.
- e) Acting Referee:** Banks may act as referees with respect to the financial standing, business reputation and respectability of customers.
- f) Underwriting Securities:** Banks underwrite the shares and debentures issued by the government, public or private companies.
- g) Gift Cheques:** Some banks issue cheques of various denominations to be used on auspicious occasions.
- h) Accepting Bills of Exchange on Behalf of Customers:** Sometimes, banks accept bills of exchange, internal as well as foreign, on behalf of their customers. It enables customers to import goods.
- i) Merchant Banking:** Some commercial banks have opened merchant banking divisions to provide merchant banking services.
- iii) Fulfilment of Socio-Economic Objectives**
- In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state.
- For example,** the nationalised banks in India

have framed special innovative schemes of credit to help small agriculturists, village and cottage industries, retailers, artisans, the self-employed persons through loans and advances at concessional rates of interest. Under the Differential Interest Scheme (DIS) the nationalised banks in India advance loans to persons belonging to scheduled tribes, tailors, rickshaw-puller, shoe-makers at the concessional rate of 4 per cent per annum. This does not cover even the cost of the funds made available to these priority sectors. Banking is, thus, being used to sub-serve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

It is clear from the above that banks help development of trade and industry in the country. They encourage habits of thrift and saving. They help capital formation in the country. They lend money to traders and manufacturers. In the modern world, banks are to be considered not merely as dealers in money but also the leaders in economic development.

1.3 EMERGING TRENDS IN COMMERCIAL BANKING IN INDIA

Q7. What are the emerging trends in commercial banking in India?

Ans :

The adoption of Information and Communication technology enable banks to provide many innovative services to the customers such as;

1. ATM Services

Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money. It is used to withdraw money, check balance, transfer funds, get mini statement, make payments etc. It is available at 24 hours a day and 7 days a week.

2. Debit Card and Credit Card Facility

Debit card is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services. It can be used in ATMs, Point of Sale terminals, e-commerce sites etc. Debit card removes the need for cheques as it immediately transfers money from the client's account to the business account. Credit card is a card issued by a financial institution giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short-term financing.

3. Tele-banking

Telephone banking is a service provided by a bank or other financial institution, that enables customers to perform financial transactions over the telephone, without the need to visit a bank branch or automated teller machine

4. Internet Banking

Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer verification. Online banking can be used to check balances, transfer money, shop online, pay bills etc.

5. Bancassurance

It means the delivery of insurance products through banking channels. It can be done by making an arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base. Banks can earn additional revenue by selling the insurance products, while insurance companies are able to expand their customer base without having to expand their sales forces

6. Mobile Banking

Mobile banking is a system that allows customers of a financial institution to conduct

a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone. Customers can access their banking information and make transactions on Savings Accounts, Demat Accounts, Loan Accounts and Credit Cards at absolutely no cost.

7. Electronic Clearing Services

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a Clearing House. This is normally for bulk transfers from one account to many accounts or viceversa. This can be used both for making payments like distribution of dividend, interest, salary, pension, etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax etc.

8. Electronic Fund Transfer/National Electronic Fund Transfer (NEFT)

National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. In NEFT, the funds are transferred based on a deferred net settlement in which there are 11 settlements in week days and 5 settlements in Saturdays.

9. Real Time Gross Settlement System (RTGS)

It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis. 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

1.3.1 E-Banking

Q8. Define E-Banking / Online banking / Internet Banking / Net Banking.

Ans :

Net Banking, E-Banking, Online banking or Internet Banking means any user with a personal computer and a browser can get connected to his bank's website to perform any of the virtual banking functions.

- In internet banking system the bank has a centralized database that is web-enabled.
- All the services that the bank has permitted on the internet are displayed in menu. Any service can be selected and further interaction is dictated by the nature of service.
- The traditional branch model of bank is now giving place to an alternative delivery channels with ATM network. Once the branch offices of bank are interconnected through terrestrial or satellite links, there would be no physical identity for any branch.
- It would be a borderless entity permitting anytime, anywhere and anyhow banking.
- The network which connects the various locations and gives connectivity to the central office within the organization is called intranet.
- These networks are limited to organizations for which they are set up.
- SWIFT is a live example of intranet application.
- Internet banking includes familiar and relatively mature electronically-based products in developing markets, such as telephone banking, credit cards, ATMs and direct deposit.
- It also includes electronic bill payments and products mostly in the developing stage, including stored-value cards (e.g., smart cards/smart money) and Internet-based stored value products.
- Internet banking is changing the banking industry and is having the major effects on banking relationships.

- Banking is now no longer confined to the branches where one has to approach the branch in person, to withdraw cash or deposit a cheque or request a statement of accounts.
- In true Internet banking, any inquiry or transaction is processed online without any reference to the branch (anywhere banking) at any time.
- Providing Internet banking is increasingly becoming a “need to have” than a “nice to have” service.
- The net banking, thus, now is more of a norm rather than an exception in many developed countries due to the fact that it is the cheapest way of providing banking services.

Objectives of Internet Banking

Following are the objectives of internet banking:

- 1) To provide services in users' own environment for convenience and accessibility.
- 2) To reduce risk of handling cash.
- 3) To provide low-cost and financial services to rural and under-served communities.
- 4) To provide a system that delivers efficient payments linked to a bank account.

Q9. Explain the uses of E-banking.

Ans :

One can avail the following services through internet banking:

1) Bill Payment Service

Each bank has tie-ups with various utility companies, service providers and insurance companies, across the country. One can facilitate payment of electricity and telephone bills, mobile phone, credit card and insurance premium bills as each bank has tie-ups with various utility companies, service providers and insurance companies, across the country. To pay the bills, simply complete a one-time registration for each biller. One can also set up standing instructions online to pay his/her recurring bills, automatically. Generally, the bank does not charge customers for online bill payment.

2) Fund Transfer

One can transfer any amount from one account to another of the same or any another bank. Customers can send money anywhere in India. Once the person log-in to his account, he needs to mention the payees's account number, his bank and the branch. The transfer will take place in a day or so, whereas in a traditional method, it takes about three working days. ICICI Bank says that online bill payment service and fund transfer facility have been their most popular online services.

3) Credit Card Customers

With Internet banking, customers can not only pay their credit card bills online but also get a loan on their cards. If anyone loses his/her credit card, he/she can report about the lost card online.

4) Investing through Internet Banking

One can now open an FD online through funds transfer. Now investors with interlinked demat account and bank account can easily trade in the stock market and the amount will be automatically debited from their respective bank accounts and the shares will be credited in their demat account. Moreover, some banks even give the facility to purchase mutual funds directly from the online banking system.

5) Recharging Prepaid Phone

Now just top-up prepaid mobile cards by logging in to Internet banking. By just selecting the operator's name, entering the mobile number and the amount for recharge, the phone is again back in action within few minutes.

6) Shopping

With a range of all kind of products, one can shop online and the payment is also made conveniently through the account. One can also buy railway and air tickets through Internet banking.

Q10. Elucidate the advantages and disadvantages of E-Banking / Online banking / Internet Banking / Net Banking.

Ans :

Advantages of Internet Banking

The advantages of internet banking are as follows:

1) Very Convenient

Internet banking is totally easy thing to do. In the comfort of home or offices, people can do whatever monetary transactions they wish to do with their bank.

2) Unlimited Service

The services and various features of bank are always available seven days a week and 24 hours daily. The most interesting thing here is that, everything can happen at just one click of mouse.

3) No Time Constraint

Internet banking is also stress free because it never closes unlike the traditional banking that has cut-off time.

4) Easy to Access

Using personal computer, people can easily do various transactions with their bank in view of their business or any other personal or financial matters.

5) Easy Way of Payment

Bill payments can also be handled properly and smartly. Instead of waiting for certain due dates, people can easily pay all their transactions using their computer and in coordination with their bank.

6) Higher Interest Rate

Another great advantage of internet banking is the interest rates which basically range from 3.40% to 5% annually. Unlike the traditional banking, online banking can earn a better interest or return of investment both in savings and checking account.

7) Easy Transaction

Another advantage is the speed of every transaction. Online transactions, compared to ATM or traditional banking, works faster. Thus, business matters could benefit so much from this speed feature.

8) Efficient and Effective

Internet banking is both efficient and effective. With just one secure site, all financial transactions can be managed orderly.

Disadvantages of Internet Banking

The disadvantages of internet banking are as follows:

1) Time Taking

In order to register for bank's online program, people will probably have to provide ID and sign a form at a bank branch. If they and their spouse wish to view and manage their assets together online, one of them may have to sign a durable power of attorney before the bank will display all of their holdings together.

2) Learning Curve

Banking sites can be difficult to navigate at first. Plan to invest some time and/or read the tutorials in order to become comfortable in virtual lobby.

3) Bank Site Changes

Even the largest banks periodically upgrade the online programs, adding new features in unfamiliar places. In some cases, people may have to re-enter account information.

4) Trust Aspect

For many people, the biggest hurdle to online banking is learning to trust it. Internet banking should be entered very carefully if people wish to enjoy their financial life.

1.3.2 Mobile Banking (M-Banking)**Q11. Define the term mobile banking (or) M-Banking.**

Ans :

Mobile banking (also known as M-Banking, SMS banking, etc.) is a term used for performing balance checks, account transactions, payments, etc., via a mobile device such as a mobile phone.

- Mobile banking today is most often performed via SMS or the Mobile Internet but can also use special programs called clients downloaded to the mobile device.
- Mobile Banking is the hottest area of development in the banking sector and is expected to replace the credit/debit card system in future.
- In past two years, mobile banking users have increased three times if it is compared with the use of either debit card or credit card. Moreover 85-90% mobile users do not own credit cards.
- Mobile banking uses the same infrastructure like the ATM solution.
- But it is extremely easy and inexpensive to implement.
- It reduces the cost of operation for bankers in comparison to the use of ATMs.

Mobile banking is defined as "Mobile Banking refers to provision and availment of banking and financial services with the help of mobile telecommunication devices. The scope of offered services may include facilities to conduct bank and stock market transactions, to administer accounts and to access customized information".

Q12. Explain the technologies enabling in mobile banking.

(or)

Discuss the various technologies used in mobile banking.

Ans :

Technically speaking most of these services can be deployed using more than one channel. Presently, Mobile Banking is being deployed using mobile applications developed on one of the following four channels:

1) Interactive Voice Response (IVR)

IVR service operates through pre-specified numbers that banks advertise to their customers. Customer's make a call at the IVR number and are usually greeted by a stored electronic message followed by a menu of different options.

- Customers can choose options by pressing the corresponding number in their keypads and are then read out the corresponding information, mostly using a text to speech program.
- Mobile banking based on IVR has some major limitations that they can be used only for Enquiry based services.
- Also, IVR is more expensive as compared to other channels as it involves making a voice call which is generally more expensive than sending an SMS or making data transfer (as in WAP or Standalone clients).
- One way to enable IVR is by deploying a PBX system that can host IVR dial plans.
- Banks looking to go the low cost way should consider evaluating Asterisk, which is an open source Linux PBX system.

2) Short Message Service (SMS)

SMS uses the popular text-messaging standard to enable mobile application based banking.

- The way this works is that the customer requests for information by sending an
- SMS containing a service command to a pre-specified number. The bank responds with a reply SMS containing the specific information.

For example,

Customers of the HDFC Bank in India can get their account balance details by sending the keyword 'HDFCBAL' and receive their balance information again by SMS. Most of the services rolled out by major banks using SMS have been limited to the Enquiry based ones.

However there have been few instances where even transaction-based services have been made available to customer using SMS.

The main advantage of deploying mobile applications over SMS is that almost all mobile phones, including the low end, cheaper one's, which are most popular in countries like India and China are SMS enabled.

3) Wireless Application Protocol (WAP)

WAP uses a concept similar to that used in Internet banking. Banks maintain WAP sites which customer's access using a WAP compatible browser on their mobile phones. WAP sites offer the familiar form based interface and can also implement security quite effectively.

Bank of America offers a WAP based service channel to its customers in Hong Kong. The banks customers can now have an anytime, anywhere access to a secure reliable service that allows them to access all enquiry and transaction based services and also more complex transaction like trade in securities through their phone.

4) Standalone Mobile Applications

Standalone mobile applications are the ones that hold out the most promise as they are most suitable to implement complex banking transactions like trading in securities. They can be easily customized according to the user interface complexity supported by the mobile. In addition, mobile applications enable the implementation of a very secure and reliable channel of communication.

Q13. What are the various services provided by the mobile banking ?

Ans :

Mobile banking can offer services such as the following:

1) Account Information: It includes:

- i) Mini-statements and checking of account history,
- ii) Alerts on account activity or passing of set thresholds,
- iii) Monitoring of term deposits,
- iv) Access to loan statements,
- v) Access to card statements,
- vi) Mutual funds/equity statements,
- vii) Insurance policy management,
- viii) Pension plan management,
- ix) Status on cheque, stop payment on cheque,

- x) Ordering cheque books,,
- xi) Balance checking in the account,
- xii) Recent transactions,
- xiii) Due date of payment (functionality for stop, change and deleting of payments),
- xiv) PIN provision, Change of PIN and reminder over the Internet,
- xv) Blocking of (lost, stolen) cards.

2) Payments, Deposits, Withdrawals and Transfers: It includes

- i) Domestic and international fund transfers,
- ii) Micro-payment handling,
- iii) Mobile recharging,
- iv) Commercial payment processing,
- v) Bill payment processing,
- vi) Peer to Peer payments,
- vii) Withdrawal at banking agent, viii) Deposit at banking agent.

3) Investments: It includes

- i) Portfolio management services,
- ii) Real-time stock quotes,
- iii) Personalized alerts and notifications on security prices.

4) Support: It includes

- i) Status of requests for credit, including mortgage approval and insurance coverage,
- ii) Check (cheque) book and card requests,
- iii) Exchange of data messages and email, including complaint submission and tracking,
- iv) ATM Location.

5) Content Services: It includes

- i) General information such as weather updates, news,
- ii) Loyalty-related offers,
- iii) Location-based services.

Q14. What are the advantages and disadvantages of mobile banking ?

Ans :

Advantages of Mobile Banking

Following are the advantages of mobile banking:

- 1) It utilizes the mobile connectivity of telecom operators and therefore does not require an internet connection.
- 2) With mobile banking, users of mobile phones can perform several financial functions conveniently and securely from their mobile.
- 3) People can check their account balance, review recent transaction, transfer funds, pay bills, locate ATMs, deposit cheques, manage investments, etc.
- 4) Mobile banking is available round the clock 24/7/365, it is easy and convenient and an ideal choice for accessing financial services for most mobile phone owners in the rural areas.
- 5) Mobile banking is said to be even more secure than online/internet banking.

Disadvantages of Mobile Banking

The disadvantages of mobile banking are as follows:

- 1) Mobile banking users are at risk of receiving fake SMS messages and scams.
- 2) The loss of a person's mobile device often means that criminals can gain access to mobile banking PIN and other sensitive information.
- 3) Modern mobile devices like Smart phone and tablets are better suited for mobile banking than old models of mobile phones and devices.
- 4) Regular users of mobile banking over time can accumulate significant charges from their banks.

1.3.3 Centralized online real time environment (CORE) banking**Q15. What is core banking ? Explain the features and advantages of core banking.**

Ans :

Core banking is normally defined as the business conducted by a banking institution with its retail and small business customers. Many banks treat the retail customers as their core banking customers and have a separate line of business to manage small business. Larger business is handled by the corporate banking division of the institution. Core banking basically is depositing and lending of money.

Now a days, most banks use core banking applications to support their operations where 'CORE' stands for "Centralized Online Real-time Environment". This basically means that all the bank's branches access applications from centralized data centres. It means that the deposits made are reflected immediately on the servers of bank and the customer can withdraw the deposited money from any of the branches of bank throughout the world. These applications now also have the capability to address the needs of corporate customers providing a comprehensive banking solution. Normal core banking functions will include deposit accounts, loans, mortgages and payments. Banks make these services available across multiple channels like ATMs, internet banking and branches.

Features of Core Banking

1. Customer relationship management features including a 360 degree customer view.
2. The ability to originate new products and customers.
3. Banking analytics including risk analysis, profitability analysis and provisions for capital reserve allocation and collateral management.
4. Banking finance including general ledger and reporting.
5. Banking channels such as teller systems, side counter applications, mobile banking and online banking solutions.

6. Best practice workflow process.
7. Content management facilities.
8. Governance and compliance capabilities such as internal controls management and auditing.
9. Security control and audit capabilities.
10. Core banking solutions to help maximize growth, increase productivity and mitigate risk.

Advantages of Core Banking

1. Limited Professional Manpower to be utilized more effectively.
2. Customer can have anywhere, more convenient and easier banking.
3. ATM, Internet Banking, Mobile Banking, Payment Gateways etc. are available.
4. More strong and economical way of management information system.
5. Reduction in branch manpower.
6. Additional manpower can be available for marketing, recovery and personalized banking.
7. Instant information available for decision support.
8. Quick and accurate implementation of policies.
9. Improved Recovery Process causing reduction on recovery costs, NPA provisions.
10. Innovative, redefined or improved processes i.e. Inter Branch Reconciliation causing reduction in manpower at Head Office.
11. Reduction in software maintenance at branch and Head office.
12. Centralized printing and backup resulting in reduction in capital and revenue expenditure on printing and backup devices and media at branches.
13. Electronic Transactions with other Financial Institutions.
14. Increased speed in working resulting in more business opportunities and reduction in penalties and legal expenses.

1.3.4 Bancassurance

Q16. What is Bancassurance ? Explain the need of Bancassurance.

Ans :

Bancassurance as an alternative distribution channel was identified as a source of improving the non-interest income of banks. The government authorities have played an active role in bancassurance implementation in an effort to keep abreast with world financial markets. Since banking services, insurance setting and fund management are all interrelated activities and have inherent synergies, selling of insurance by banks would be mutually beneficial for both banks and insurance companies.

Bancassurance, in its simplest form, is distribution of insurance products through a bank's branch network. Hence, there is a room for bancassurance where banking and insurance congregate with each other. It is a service that can fulfill both banking and insurance needs at the same time. Bancassurance as a concept first began in India when the insurance industry opened up to private participation in December 1999.

Bancassurance simply means selling of insurance products by banks. In this arrangement, insurance companies and banks undergo a tie-up, thereby allowing banks to sell the insurance products to its customers. This is a system in which a bank has a corporate agency with one insurance company to sell its products. By selling insurance policies bank earns a revenue stream apart from interest. It is called as fee-based income. This income is purely risk free for the bank since the bank simply plays the role of an intermediary for sourcing business to the insurance company.

Reasons/Needs of Bancassurance

The reasons or needs of bancassurance are explained as follows:

1) Reasons for Banks' Eagerness to Collaborate with Insurance Companies:

- i) Attraction of fee income,
- ii) Diversion of surplus workforce, and
- iii) Development of product range

2) Reasons for Insurance Companies' Eagerness to Collaborate with Banks:

- i) Reliance on wide network,
- ii) Attraction of strong clientele base, and
- iii) Aggressive marketing strategies.

3) Reasons for Consumers' Eagerness to Welcome Bancassurance

Consumer perception is itself a very dynamic phenomenon. Today's customer is very demanding and sensitive too. Customer expectations in respect of service quality are quite high. Consumers insist on respectable behaviour from their banker. Now, when there are so many operators, they can always switch over their loyalty at any moment. Thus, there is a challenge before service providers that their clientele base is retained. In regard to quality of service, our public sector banks are certainly required to redefine their priorities and strategies because very often they are labelled as poor. The competitive state of market suits the consumer as customer care is always better. The customer will be benefited the most if the market is developed and competition is aroused to a greater extent.

Q17. What are the functions of Bancassurance?

Ans :

There are many ways a bank and an insurer can cooperate or combine to form a bancassurance operation.

1) TTBank as an Agent

In a bank agency arrangement, the bank distributes life insurance products as an agent. The insurance products are "off the-shelf" and are not customized for bank distribution. The bank receives commissions for selling the products.

2) Partnership

In a partnership arrangement, both entities have a stake in the success of the venture. The strength of the partnership determines the level of commitment by the partners. In

a strong partnership the companies could engage in cross holding of equity, make mutual investments and enter into a long-term exclusive selling arrangement. A weak partnership agreement may last a few years and involve a limited amount of mutual effort.

For the bank, a weak partnership agreement provides a strategic advantage. The bank gains knowledge about the insurance business with little commitment. At the end of the partnership agreement, the bank will have the option of exploring any of the organizational strategies with the advantage of a customer base and extensive insurance knowledge gained from the insurer.

3) Joint Venture

In a joint venture arrangement, both the bank and insurer own a stake in a new insurance company.

4) Bank Manufacturer

In the bank manufacturer strategy, the bank and insurer are a vertically integrated company.

Q18. State the advantages and disadvantages of Bancassurance?

Ans :

Advantages of Bancassurance

- 1) Every insurance company wants to grow quickly to reduce painful start-up expense overruns. Banks with their huge networks and large customer bases give insurers an opportunity to do this efficiently.
- 2) It gives the companies an opportunity to tap the rural sectors. Selling insurance through traditional methods in these sectors is very expensive. A tie-up with a bank with an appropriate customer base can give an insurer a cheap access to these areas.
- 3) Bancassurance enables to have a huge pool of skilled professionals.
- 4) The margins of the banks in their core lending business are declining sharply. Opportunities like bancassurance augment their income.

- 5) Bancassurance enables to develop a sales culture within the bank. It helps to change the traditional mindset of banking companies.
- 6) The distribution of insurance products through banks has been beneficial to both insurance and banking companies as well as the customers.

Disadvantages of Bancassurance

Following are the disadvantages of bancassurance:

- 1) Economic viability for the banks to take-up as bancassurance is a volume business.
- 2) Training of people and lack of vision and awareness.
- 3) Useful for selling only certain lines of products.
- 4) Initial investment in systems and processes and people training.

1.3.5 Banking OMBUDSMAN

Q19. Who is a banking ombudsman ? What types of complaints can be filled before a banking ombudsman ?

Ans :

Banking ombudsman refers to a person appointed by the Reserve Bank of India to redress consumer complaints against any bank in India. Thus it can be said that a banking ombudsman acts as an official judge and grievance redresser who is entrusted with the responsibility of redressing the complaints of the banking customers.

The banking ombudsman is appointed by the Reserve Bank of India in accordance with the Banking Ombudsman Scheme, which was first introduced in the year 1995. This scheme was later revised in the year 2002 and again in the year 2006.

The banking ombudsman is a Quasi judicial authority and has the power to order both the parties (i.e., bank and customer) to complain. At present, in India 15 banking ombudsman had been appointed and they are located in major state capitals across the country.

Types of Complaints filed before Banking Ombudsman

The following are the types of complaints that are received and resolved by a banking ombudsman,

1. Complaints related to non-payment of cheques, drafts, bills etc.
2. Banks not working as per the stipulated working hours.
3. Failure on the part of the bank to provide the banking services which had been promised by the bank in writing. (It does not include the facility to provide loans and advances).
4. Failure on the part of the bank to honour letter of credit.
5. Non acceptance of coins or any other denomination of the legal tender by the bank, without providing any valid reason.
6. Non-adherence on the part of the banks to adhere to fair business practices, adopted by the banking industry.
7. Refusal on the part of the bank to accept taxes, as per the rules of the RBI or the central government.
8. Refusal or delay towards redemption of government securities.
9. Forceful closure of the customers bank account, without providing any genuine reason for doing so.
10. Refusal to open a bank account, without providing any valid reason.
11. Levying of charges against the services provided without prior intimation.
12. Non acceptance on the part of the bank, of small denominations of currency without providing any valid reason.

Q20. What are the powers of banking ombudsman?

Ans :

The powers and duties of the Banking Ombudsman may be classified under two heads, namely:

- (i) General powers
- (ii) Specific powers

i) General power

The general powers of the Banking Ombudsman are:

- (a) To receive complaints relating to the provision of banking services.
- (b) To consider such complaints and facilitate their satisfaction, or settlement by agreement or settlement by recommendation or settlement by an Award as the case may be in accordance with the provisions under this scheme.
- (c) The Ombudsman has all powers of a Court.

ii) Specific power

To be more specific, the Banking Ombudsman can receive all complaints regarding deficiency in banking services such as:

- (a) Non-payment or inordinate delay in the payment or collection of cheques, drafts, bills, etc.
- (b) Non-acceptance of small denomination notes without assigning any reason and for charging of commission in respect thereof.
- (c) Non-issue of drafts to customers as well as to outsiders.
- (d) Non-adherence to prescribed working hours by branches.
- (e) Failure to honour guarantee or letter of credit commitments by bankers.
- (f) Claims in respect of unauthorised or fraudulent withdrawals from deposit accounts.
- (g) Complaints relating to deposits such as delay in collection, non-credit of proceeds to parties accounts, non-payment of deposit or non-observance of RBI's directives relating to rate of interest on deposits.
- (h) Complaints from Indian exporters regarding delays in receipt of export proceeds, handling of export bills, collection of bills, etc. provided such complaints pertain to the bank's operations in India.
- (i) Complaints of non-resident Indians relating to their remittances from abroad, deposits and other bank-related matters.

As far as the loans and advances are concerned, he can receive complaints such as:

- (a) Non-observance of prescribed time schedule for disposal of loan applications.
- (b) Delays in sanction or non-observance of prescribed time scheduled for disposal of loan applications.
- (c) Non-observance of any other directions of the RBI issued from time to time.

1.4 RBI CONSTITUTION
Q21. Explain the Constitution of RBI.

Ans :

Introduction

The **Reserve Bank of India (RBI)** is the apex financial institution of the country's financial system. It is entrusted with the task of control, supervision, promotion, development and planning.

The Reserve Bank of India influences the management of commercial banks through its various policies, directions and regulations. Its role in bank management is quite unique. It performs the four basic functions such as planning, organizing, directing and controlling in laying a strong foundation for the functioning of commercial banks.

The Reserve Bank of India is India's central bank. It came into existence on 1st April 1935 under the Reserve Bank of India Act, 1934.

History of Reserve Bank of India (RBI)

In 1921, the Imperial Bank of India was established to perform as central bank of India by the British Government. But unfortunately Imperial Bank failed to show its performance up to the mark and didn't achieve any success as the Central Bank. Then the Government asked the Hilton Young Commission in 1925 to view on this subject.

The commission submitted their reports saying that one single organization can't be able to act as two separate agencies (both credit and currency control). So, it's required to set up a brand new central bank. In 1st April 1935, Reserve Bank of India was set up. In January, 1949, RBI was nationalized.

RBI Constitution.

The Reserve Bank was originally constituted as a shareholders' bank with a capital of ` 5 crore divided into five lakh fully paid-up shares of ` 100 each. The entire share capital was contributed by private shareholders with the exception of the nominal value of ` 2.2 lakh subscribed by the Central Government.

Nationalisation of RBI

After independence, the public opinion was strongly in favour of nationalisation of the Reserve Bank. A decision was taken in this regard in 1947. Consequently, the Reserve Bank of India (Transfer to Public Ownership) Act, was passed in 1948. The entire share capital of the Bank was acquired by Central Government against compensation to shareholders at ` 118.10 per share. From 1st January, 1949, it began to function as a government owned institution.

1.4.1 Organizational Structure - Management**Q22. Explain management and organizational structure of RBI.**

Ans :

Management

The management of RBI is divided into two parts, they are,

1. Central Board of Directors
2. Local Boards.

1. Central Board of Directors

The RBI is controlled by central board of directors which comprises of 20 members.

- (i) One governor and four deputy governors are nominated by the central government from ministry of finance as per the Reserve Bank of India for a 4 years.
- (ii) Four directors appointed by the central government under section 8(1(b)). Four zones (N, E, W, S) from various interest experts
- (iii) Ten directors appointed by the central government under section 8(1(c)).
- (iv) Control boards head quarters is in Mumbai, local board is in Chennai, Kolkata.
- (v) The governor is the chairman of Central Board of Directors of the RBI. In governor's absence, the Deputy Governor is appointed to exercise the powers of governor.

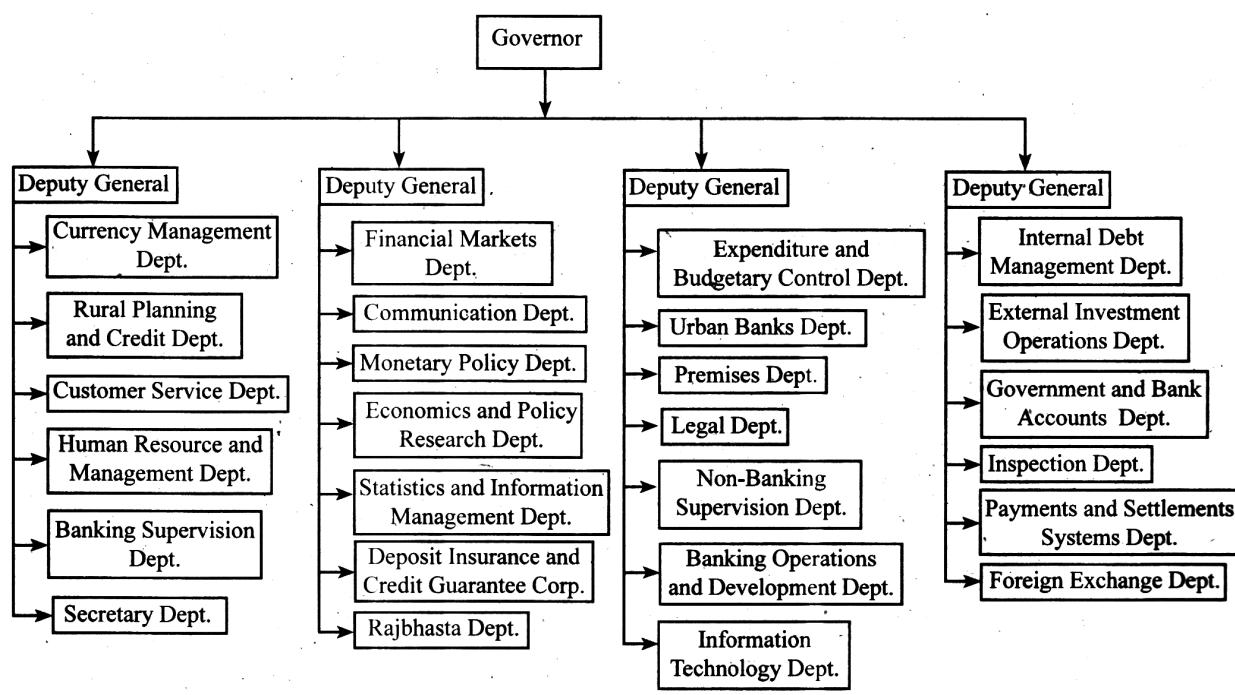
2. Local Boards

The local boards of RBI consist of five members, appointed by the central government for a four year term. The members of each local board elects their own chairman. The local boards represent economic and territorial interest and the interest of cooperatives and indigenous banks. These local boards has limited powers.

Organizational Structure of RBI

The organizational structure of RBI is classified into 26 departments. These departments aim on policy issues in their respective areas. In addition to these departments, RBI has 26 regional offices and branches that operate as training centers, research institutes and subsidiaries.

The following figure depicts the organizational structure of RBI,



1.4.2 Objectives of RBI

Q23. What are the Objectives RBI ?

Ans :

1. To act as Monetary Authority

Formulates implements and monitors the monetary policy to maintain price stability and ensuring adequate flow of credit to productive sectors.

2. To Regulate and supervise the financial system of the country

It prescribes broad parameters of banking operations within which the country's banking and financial system functions. It helps to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3. To Manage the Exchange Control

Manages the Foreign Exchange Management Act, 1999 to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. To issue currency

Issues and exchanges or destroys currency and coins not fit for circulation to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5. To undertake developmental role

RBI performs a wide range of promotional functions to support national objectives.

6. To undertake related Functions by acting as :

- ▶ Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- ▶ Banker to banks: maintains banking accounts of all scheduled banks.
- ▶ Owner and operator of the depository (SGL-Subsidiary General Ledger account) and exchange (NDS)

1.4.3 Functions of RBI

Q24. What are the various functions of RBI?

Ans :

The Reserve Bank of India Act, 1934, confers upon it the powers to act as note-issuing authority, banker's bank to the Government. As the Central Bank of the country, the Reserve Bank of India performs both the Traditional Functions of a central bank and a variety of developmental and promotional functions.

The Functions of RBI

1) Monetary Functions

- a) Bank of Note Issue
- b) Currency Chest
- c) Banker to Government
- d) Bankers Bank
- e) Lender of the Last Resort
- f) Banker, Agent & Adviser to the Government
- g) Custodian of the Cash Reserves of Commercial Banks
- h) Custodian of Foreign Balances of the Country
- i) Controller of Credit

2) Non-Monetary Functions

- a) Supervisory Functions
- b) Promotional Functions

1. Monetary Functions

a) Bank of Note Issue

The currency of our country consists of one-rupee notes and coins (including subsidiary coins) issued by the government of India and bank note issued by RBI. As required by Section 38 of RBI Act, government puts into circulation one rupee coins & notes through RBI only. RBI has the sole right to issue bank notes in India. The notes issued by RBI and the one-rupee notes & coins issued by the government are unlimited legal tender. RBI also bears the responsibility of exchanging notes & coins into those of other denominations as required by the public.

The assets of the Issue Department against which bank notes are issued consist of the following:

- Gold Coins & Bullion
- Foreign Securities
- Rupee Coins
- Government of India Rupee Securities
- The bill of exchange and promissory notes payable in India, which are eligible for purchase by the Bank.

b) Currency Chest

RBI has made adequate administrative arrangements for undertaking the function of distribution of currency notes & coins. The Issue department has opened its offices in 10 leading cities for this purpose. More over, currency chest have been maintained all over the country to facilitate the expansion and contraction of currency in the country.

c) Banker to Government

RBI to the central & state Government. According to section 20 of RBI Act, 1934 it is obligatory for the RBI to transact government business including the management of the public debt of the union. Section 21 requires the Central Government to entrust RBI all its money, remittance, exchange and banking transactions in India and, in particular,

deposits free of interest all its cash balances with RBI.

In terms of section 21-A, RBI performs similar function on behalf of the State Government. RBI has entered into agreements with the Central and State Government for carrying out these functions.

For conducting ordinary banking business of the Central Government, RBI is not entitled to any remunerations it holds cash balances of the Government of the Government free of interest. For the management of public debt, RBI is entitled to charge a commission. RBI is also required to maintain currency chests of its Issue Department at places prescribed by the Government and to maintain sufficient notes & coins therein.

d) **Bankers Bank**

RBI is the banker to the banks – Commercial, Co-operative & Regional Rural Banks (RRBs). This relationship is established once the name of a bank is included in the second schedule to the RBI Act, 1934. Such banks are called scheduled banks. The category of scheduled banks includes.

- i) Commercial Banks – Indian and foreign
- ii) Regional Rural Banks &
- iii) State Co-operative Banks

A '**Schedule Bank**' means a bank included in the second schedule to the RBI Act, 1934. The Reserve Bank is empowered to include in the second schedule the name of a bank, which carries on the business of banking in India and which satisfies the following conditions laid down in section 42(6):

- i) It must have a paid-up capital and reserve of an aggregate value of not less than Rs.5 lakhs;
- ii) It must satisfy RBI that its affairs are not being conducted in a manner determined to the interest of its depositors, &
- iii) It must be;
 - A state co-operative bank or

- A company as defined in the companies act, 1956, or

- iv) An institution notified by the central government in the behalf, or
- v) A corporation or a company incorporated by or under any law in force in any place outside India.

e) **Lender of the Last Resort**

As the banker to the banks, RBI acts as the lender of the last resort and grants accommodation to the scheduled banks in the following forms;

- i) Re-discounting or purchase of eligible bills, Section 17(2) & (3)
- ii) Loans and advances against certain securities, Section 17(4)
- iii) Re-discounting of Bills. Section 17(2) lays down that the following categories of bill are eligible for re-discounting with the Reserve Bank.

- Commercial Bills
- Bill of Financing Agricultural Operations
- Bill of financing cottage and small-scale industries
- Bill of holding or trading in Government Securities
- A foreign bill

- iv) **Loans & Advances:** Section 17(4) enables RBI to grant loans, & advances to the scheduled banks, repayable on demand or on the expiry of fixed periods not exceeding 90 days against the security of the following :

- Stock, funds and securities (other than immovable property) in which a trustee is authorized to invest trust money
- Gold or silver or documents of title to the same

- Such bills of exchange and promissory notes as are eligible for purchase or re-discount by RBI (state above) or those guaranteed by the state governments as the repayment of the principal and interest.
- Promissory notes of any scheduled bank or state co-operative Bank support by documents of title to goods.

f) Banker, Agent & Adviser to the Government

Central banks everywhere perform the functions of banker, agent and adviser to the Government. As banker to the Government, the central bank of the country keeps the banking accounts of the Government-both of the Centre & of the States-performs the same functions as a commercial bank ordinarily does for its customers.

As a banker and agent to the Government, the central bank makes and receives payments on behalf of Government. It helps the Government with short-term loans and advances (known as ways and means advances) to tide over temporary difficulties and also floats public loans for the Government. It also manages the public debt (i.e., floats, services & redeems Government loans). It advises the Government on monetary and economic matters

g) Custodian of the Cash Reserves of Commercial Banks

All commercial banks kept part of their cash balances as deposit with the central banks of the country, either because of convention or because of legal compulsion. They regularly draw currency from the central bank during the busy season and pay in surplus currency during slack season. Part of these balances are meant for clearing purposes. That is all commercial banks keep deposit accounts with central bank, payment by one bank to mother will be simple book entry adjustment in the books of the central bank. The deposit balances with central bank are considered as cash reserves for general purposes.

h) Custodian of Foreign Balances of the Country

Under the gold standard, countries maintained gold as reserve against the issue of currency. But after World War 1, the central banks in most countries have maintained both gold as well as foreign currencies as reserves against note issue and also to meet any adverse balance of payments with any other country. It is the responsibility of the central bank of the country to maintain the rate of exchange fixed by the Government and manage exchange control and other restrictions imposed by the state.

i) Controller of Credit

Probably the most important of all the functions performed by a central bank is that of controlling the credit operations of commercial banks. In modern times bank credit has become the most important source of money in the country, relegating coins and currency noted to a minor position. Moreover, it is possible, as we have pointed out in a previous chapter, for commercial banks to expand credit and thus intensify inflationary pressure or contract credit & thus contribute to a deflationary situation. It is, thus, of great importance that there should be some authority which will control the credit creation by commercial banks. As controller of credit the central bank attempts to influence and control the volume of bank credit & also to stabilize business conditions in the country

2. Non-Monetary Functions

a) Supervisory Functions

In addition to its traditional central banking functions, RBI has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The RBI Act, 1934, and the Banking Regulation Act, 1949, have given RBI wide powers of supervision and control over commercial and co-operative banks relating to licensing and establishment, branch expansion, liquidity of their assets, management and methods of working, amalgamation, re-construction and

liquidation. RBI is authorised to carry out periodical inspections of the banks and a call for returns and necessary information from them. The nationalization of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on RBI for redirecting the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives. The supervisory functions of RBI have helped a great deal in improving the standard banking in India to develop on sound lines and to improve the methods of their operation.

b) Promotional Functions

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

Accordingly, RBI has helped in the setting up of IFCI and SFCs; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Re-finance Corporation of India in 1963, the Industrial Re-constructions Corporation of India in 1972 & NABARD in 1982. These institutions were set up directly or indirectly by RBI to promote savings habit and to mobilize savings, to provide industrial finance as well as agriculture finance.

1.5 MONETARY POLICY

Q25. Define monetary policy. What are the objectives of monetary policy ?

Ans :

Meaning

The term monetary policy is also known as the 'credit policy' or called 'RBI's money management policy' in India. How much should be the supply of money in the economy? How

much should be the ratio of interest? How much should be the viability of money? etc. Such questions are considered in the monetary policy. From the name itself it is understood that it is related to the demand and the supply of money.

Definitions

Many economists have given various definitions of monetary policy. Some prominent definitions are as follows.

- i) **According to Prof. Harry Johnson**, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."
- ii) **According to A.G. Hart**, "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

Objectives of Monetary Policy

The following are the principal objectives of monetary policy:

1. Full Employment

Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect.

2. Price Stability

One of the policy objectives of monetary policy is to stabilize the price level. Both economists and laymen favour this policy because fluctuations in prices bring uncertainty and instability to the economy.

3. Economic Growth

One of the most important objectives of monetary policy in recent years has been the

rapid economic growth of an economy. Economic growth is defined as “the process whereby the real per capita income of a country increases over a long period of time.”

4. **Balance of Payments**

Another objective of monetary policy since the 1950s has been to maintain equilibrium in the balance of payments.

5. **Controlled Expansion Of Bank Credit**

One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

6. **Promotion of Fixed Investment**

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

7. **Restriction of Inventories**

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

8. **Promotion of Exports and Food Procurement Operations**

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

9. **Desired Distribution of Credit**

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

10. **Equitable Distribution of Credit**

The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

11. **To Promote Efficiency**

It is another essential aspect where the central banks pay a lot of attention. It tries to increase

the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.

12. **Reducing the Rigidity**

RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

Q26. Explain the features of monetary policy.

Ans :

The main features of the monetary policy of the Reserve Bank of India are given below:

1. **Active Policy**

Before the advent of planning in India in 1951, the monetary policy of the Reserve Bank was a passive, cheap and easy policy. It means that Reserve Bank did not use the measures of monetary policy to regulate the economy.

For example from 1935 to 1951, the bank rate remained stable at 3%. But since 1951, the Reserve Bank has been following an active monetary policy. It has been using all the measures of credit control.

2. **Overall Expansion**

An important feature of Reserve Bank's monetary policy is that of overall expansion of money supply. In the words of S.L.N. Sinha 'The Reserve Bank's responsibility is not merely one of credit restriction.

In a growing economy there has to be continuous expansion of money supply and bank credit and the central bank has the duty to see that legitimate credit requirements are met'. In fact, the overall, trend of money supply has been one of the expansions along with an almost continuous rise in price level.

3. **Seasonal Variations**

The monetary policy is characterised by the changing behaviour of busy and slack seasons.

These seasons are tied to the agricultural seasons. In the busy season there is an expansion of funds on account of the seasonal needs of financing production, and inventory building of agricultural commodities.

On the other hand, the slack season is characterised by the contraction of funds due to the return flow. It may be pointed out that aggregate contraction of funds during the slack season has tended to fall far short of expansion in the preceding busy season.

The main reason behind this changing pattern is the requirement of additional funds by the industrial sector. Thus, during busy season the Reserve Bank adopts an expansionary credit policy and tightens the liquidity pressures during the slack season.

4. Tight and Dear Monetary Policy

In order to restrain inflation the Reserve Bank has often adopted a tight and dear monetary policy. A tight monetary policy implies that the rate of growth of money supply is lowered. A dear money policy refers to increase in bank rate. This increase in bank rate leads to an increase in the interest rates charged by the banks.

5. Investment and Saving Oriented

The monetary policy adopted by the Reserve Bank is both investment and saving oriented. To encourage investment, adequate funds were made available for productive purposes at reasonable rates of interest. The Reserve Bank has also kept the interest on deposits at a reasonable rate to attract savings.

6. Imbalance in Credit Allocation

The monetary policy is biased towards industrial sector. Agriculture does not get the required institutional finances. Consequently, it has to depend upon money lenders to a considerable extent for its credit needs.

The agricultural sector has to pay high rate of interest and even then does not get required amount of capital. A large part of funds flows to large industries. Even small scale industries

suffer from the inadequacy of finances. Thus monetary policy has resulted in imbalances in credit allocation.

7. Wide Range of Methods of Credit Control

The Reserve Bank has used a wide range of instruments of credit control. It has adopted all the measures of quantitative and qualitative credit controls to meet the needs of a complex and varying economic situation. Since the objective has been to achieve economic growth with stability, the policy of monetary management has gone beyond the traditional regulatory function. It has adopted a more positive role of channeling credit to desired sectors.

8. Guiding Factors

According to Shri. C. Rangarajan the following three factors have essentially guided the conduct of monetary policy:

- (i) Monetary policy measures have generally been a response to fiscal policy.
- (ii) While monetary policy has been primarily acting through availability of credit, the cost of credit has also been adjusted upwards sometimes very sharply to meet effectively the inflationary situations.
- (iii) The areas of operation of monetary policy did not remain confined to those related to regulation of monetary authority in the allocation of credit to the non-Government sector because of an important element of national economic policy, specially after the nationalisation of banks.

Q27. State the recent trends in monetary policy.

Ans :

The Reserve Bank of India is responsible for developing and conducting the monetary policy. It focuses on the economic growth by changing the monetary policy. The policy is reviewed quarterly and released annually in the month of April.

The Governor of RBI, D. Subba Rao, released the latest monetary policy on 20th April, 2010 for the year 2010-11. The following are some of the major changes made by the RBI in the monetary policy,

1. Cash Reserve Ratio(CRR)

In India maintaining CRR is statutory. In countries like England, USA its not compulsory. However CRR is compulsory according for government of India to RBI. RBI has right to change CRR Rate. In 1962 it increased to 15%.

CRR refers to the percentage of cash deposits which the banks have to maintain with the RBI. The CRR was increased by 75 points by the RBI in January 2010 which led to the consumption of ` 36,000 crores from the system. The CRR was increased by 25 basis points i.e., from 5.75% to 6.0% in the annual policy. This step ensured that more cash will be deposited by banks in the RBI. But the cash deposited does not give any return to the banks thereby effecting its liquidity. The banks cannot grant loans due to the less availability of cash. This also results in higher interest rates. The RBI had reduced the CRR in 2008 and 2009 to ensure higher liquidity in the banking system.

2. Repo Rate

The rate at which RBI purchase government securities. RBI introduced repurchase auctions (Repos) since December 1992 in respect of dated central government securities. The interest rate at which the RBI grants money to banks is known as repo rate. In other words, it is the RBI's lending rate to other bank. The reduction in repo rate increases the borrowing rate of banks and helps in reducing the interest rates.

The reserve repo rate stands adjusted at 7.0% in Jan. 2014. In September 2010-11, the RBI increased the repo rate by 25 basis point i.e., from 5.75% to 6.0%. This indicates that borrowing from RBI is very costlier for the banks.

3. Reverse Repo Rate

To sell government securities through cut off rate of interest by auction is called as reverse repo. November 1996, RBI introduced "reverse repos" i.e. to sell government securities through auction at fixed cut off rates of interest. The rate at which RBI borrows money from other banks is known as reverse repo rate. In other words, it is the RBI's borrowing rate. It is the complete opposite of repo rate.

Reserve repo rate is a type of tool that RBI uses when it finds that there is too much money in the banking system. The commercial banks get a higher interest rate on the funds given to RBI, if the reverse repo rate is increased. As keeping money with RBI is risk-free, banks usually prefer to maintain their money with RBI than to lend it to borrowers as lending to borrowers could be more risky.

The reverse repo rate has been increased by 50 basis point i.e., from 4.5% to 5.0% by the RBI in the annual monetary policy. This enables the other banks to earn higher returns by lending to the RBI, which signifies an increase in deposit rates.

The other important policy rates are as follows:

Policy rates	Base rate 6.0%	Repo rate 6%	Reverse repo 5%
Reserve ratio	CRR	6.0%	SLR 25%
Lending/deposit ratios	Base rate 7.5%-8%	Saving banks rate 3.5%	Deposit rates 6%-7.5%

4. Statutory Liquidity Ratio (SLR)

The amount of liquid assets that the bank has to keep as an assured amount of funds is known as SLR. The funds may be in the form of cash, government bonds, gold etc. In the monetary policy of 2009 the RBI had increased the SLR by 100 basis points i.e., from 24% to 25%.

There has been no change in the SLR in the annual monetary policy of 2010-11. The SLR controls the credit expansion of banks and can increase the interest rates.

5. Inflation Projection for 2010-11

RBI has projected the WPI (Wholesale Price Index) inflation to 5.5%. According to the policy, the inflation risk is higher due to domestic demand and increase in the price of the commodities globally.

6. Money Supply

The money supply decreased from 20% to 16.4% in 2009-10. However, it increased to 16.8% in March 2010. The policy is seeking to increase the money supply to 17% in 2010-11.

7. Bank Rate

The monetary policy of 2010-11 retained the bank rate at 6%.

8. Introduction of Base Rate System

RBI indicated the introduction of base rate system in the annual policy. A group for reviewing the current Benchmark Prime Lending Rate (BPLR) system and recommending the changes for making credit policy more clear and transparent was setup under the leadership of Deepak Mohanty. The guidelines to the base rate system were introduced in February 2010 and the base rate system came into effect from 1st July, 2010.

9. Interest Rate Futures

The policy introduced the interest rate future contract on 5 year and 2 year notional coupon bearing securities and 91 days treasury bills, in 2010-11. Earlier in 2009, the interest rate futures contract was on 10 year notional coupon bearing government of India security.

1.6 BRIEF DESCRIPTION ON VARIOUS TYPES OF BANKS

1.6.1 District Co-Operative Central Banks (DCCB)

Q28. What is District Co-Operative Central Bank (DCCB)? Explain the objectives of DCCB.

Ans :

District Central Co-operative Bank (DCCB)

District Central co-operative Bank (DCCB) refers to a network of co-operative banking established by the government of India for the purpose of providing banking facilities in the rural and semi-rural areas of India. The main objective of this bank is providing agricultural loans, consumer banking, co-operate banking, mortgage loans etc in rural and semi rural areas in every district of India. The district co-operative central bank is popularly called as DCC bank.

As the DCC bank is located in every district in every state of India these fore, it is formed on the name of the district where it is located. For example, the DCC bank located in Hyderabad district would be named as "Hyderabad DCC Bank". The directors and members consist of rural workforce including rural co-operatives, milk unions, agricultural and non- agricultural co-operatives and so on. All the DDC banks located in a particular state are headed by the state apex central co-operative bank, which is generally located in the capital of every state. Thus, the hierarchy of the DCC Banks is made to ensure that rural consumers get easy access to these banks.

Objectives

- i) To finance the primary societies for agricultural purposes.
- ii) To attract local deposits.
- iii) To develop and extend banking facilities in rural areas and make the people banking minded.
- iv) To provide a safe place for investing the reserves of the primary societies.

- v) To develop the co-operative movement in the district and act as a friend, philosopher and guide and ;
- vi) To Supervise the working and management of the affiliated societies.

Q29. Explain the growth and development of DCCB.

Ans :

When the Co-operative Societies Act was passed in 1904 there was no provision for the formulation of central societies or central banks.

- The sponsors of the co-operative movement expected that the rural credit societies would be able to attract substantial deposits from the bankers and well-to-do sections of the village community and their savings would be available to meet the needs of the needy in the villages.
- It was also contemplated that any deficiency in the funds would be made good by loans from the Government.
- The first central bank was registered in Uttar Pradesh in 1906 as a primary society.
- But the first perfect central Bank in the modern sense saw the light of the day in the former Central Provinces and Berar. In Rajasthan, the first central co-operative bank was started in 1910 at Ajmir.
- The years from 1906 to 1918 may be called the period of origin of the co-operative banks in various parts of the country.
- At the end of the first world war, there was a marked expansion of co-operative banking system.
- The number of central co-operative banks increased from 233 in 1919-20 to 588 in 1929-30. While their membership increased from 1.22 lakhs to 1.91 lakhs, the total working capital rose from Rs.6.43 crores to Rs.30.90 crores.
- The effects of depression in the Thirties adversely affected the working of the central co-operative banks.

- There was marked increase in the number of central co-operative banks from 588 in 1929-30 to 611 in 1936-37 due to the registration of new banking unions in the former Princely State and Uttar Pradesh & Bihar.
- There were 505 central co-operative banks as on 30th June, 1951.
- Their number reduced to 478 in 1956 and got further reduced to 372 at the end of June 1964.
- The reduction in number was the net result of amalgamation of central co-operative banks.
- In 1969, the total number of central co-operative Banks stood at 342 as against 347 in 1967.
- The Central Co-operative Banks continued their efforts to expand banking business.
- As a result, the total number of banks increased to 344 at the end of June 1976 and remained the same till the end of June 1978.
- According to the Reserve Bank of India Annual Report (1987-82), the total number of Central Co-operative Banks as on June 1982 stood at 346 as compared to 347 banks as on June 1981.
- Since then, during the plan period the policy of reorganization and amalgamation has been followed, as a result of which the number of District Central Co-operative Banks has been reduced and they stood at 340 during 1983-84.
- The DCCBs were established to finance the primary societies and to act as their balancing centre. They do stand at the intermediate stage in the structure of the co-operative movement in the country.
- They form a useful link between, the primary societies at the base and the state co-operative banks at the top.

The DCCBs are expected to maintain close and continuous touch with the primary societies, by sympathetic and responsive to their needs and difficulties and provide leadership to them.

Q30. What are the various sources of funds used for financing District Co-Operative Central Banks in India.

Ans :

The DCC Banks derive their working capital from the following sources,

(a) Share Capital

It is the most common source of financial funds for the DCC Banks wherein the DCC bank issues shares to its individual members and society members. Generally majority of the shares are issued to society members and the value of each share may range between ` 50 upto ` 100.

It is mandatory for the DCC bank to maintain sufficient paid up capital. In a recent survey conducted by the all India rural credit survey committee it has been observed that the respective state government are providing substantial amount of the paid up capital for the DCC banks.

(b) Public Deposits

Another important source of funds for the DCC banks are the public deposits that it could gather from the bank customers in the form of bank savings. Therefore the larger the amount of public deposits, the greater would be the finances of the DCC Bank.

(c) Loans

Loans from the state government, central government or other approved financial institution also forms an important source of funds for the DCC Banks. The borrowing powers of DCC banks are filled under the following rules,

- (i) Rules of the co-operative society area.
- (ii) Rules under various bye-laws.
- (iii) Rules framed by the registrar of co-operative society.

(d) Reserve Funds

By law, the DCC banks are required to maintain different kinds of reserves, which may be utilized for the purpose of financing

the banks rural customers. Generally, the DCC bank would maintain three kind of reserves statutory reserve, bad debt reserves and other reserves. Apart from these reserves, the DCC banks may maintain other reserves such as dividend reserve, building fund reserve, sinking fund reserve, investment depreciation reserve etc.

(e) Government Grants

Financial grants and assistance from the central government and the state government also form an important part of the source of fund for the DCC banks the government of India may provide financial grants under the various welfare programs to the DCC banks with the aim of providing financial credit and assistance to the rural customers across the country.

1.7 CONTEMPORARY BANKS

Q31. Explain the various Contemporary Banks in India.

Ans :

1. Women's Bank

The Union Budget 2013-14 has announced to set up a bank exclusively for women as a public sector bank with ` 10 billion as initial capital. The RBI has given licence to it on Sept. 25, 2013. Its registered office will be at New Delhi. Its main focus is on women in rural centres for which has proposed to open at least 25% of its branches in unbanked rural centres it is India's first women's bank and it is called Bharatiya Mahila Bank Ltd. It is a channel for women's education, employment an empowerment. Though it accepts deposits from anybody, it lends predominantly to women. It is proposed to open 25 branches in 2013-14 and 55 branches in 2014-15.

The bank has designed special loan products to women such as loans to set up beauty parlours, day care centres, catering units etc. As a part of banking reforms, now it has been merged with the State Bank of India from 1st April, 2017. This merger has resulted in the transfer of 103 branches and ` 2000 crores of business to the SBI.

2. Payments Banks

Payments banks are those banks which have been established to accelerate financial inclusion by means of opening small savings accounts and also by providing easy payments/remittance services. These banks are expected to cater to the requirements of vulnerable groups such as weaker sections and low income groups through their mobile phones rather than by opening physical branches. These banks can raise deposits upto ` 1 lakh and transact other businesses like remittances, payment of utility bills, cashless purchases, etc. through a mobile phone. They can also issue ATM/Debit cards and offer internet facilities. They can act as Business

Correspondents of other commercial banks. But, these banks can not under take any lending activities and hence they need not face any credit and market risks. Hence, the minimum paid up capital has been fixed at ` 100 crore.

These banks are expected to operate in remote areas mostly through Business Correspondents. ATMs and other networks. They have to use the words 'Payments Bank' in their name in order to differentiate them from other banks. So far, the Reserve Bank of India has granted permission to 11 entities to act as Payments Banks. These banks have to be registered as a public limited company under the Companies Act 2013 and licensed under Sec.22 of the Banking Regulations Act, 1949.

3. Small Finance Banks

Small finance banks are those banks which have been set up to provide the basic banking services to the unserved and underserved sections of the society such as small business units, Small and marginal farmers, micro and small industries and other entities in the unorganised sector.

The main objective of these banks is to provide financial inclusion by accepting deposits and lending money to the less privileged sections in unbanked areas. They must be registered under the Companies Act 2013 and licensed under Sec. 22 of the Banking Regulations Act, 1949. The minimum paid up capital shall be ` 100 crore with the promoter's contribution of 40%. An existing Non-banking Financial Company or Mutual Fund Institution or Local Area Bank may convert itself

into a small finance bank. They must use the words 'Small Finance Bank' in their name in order to differentiate them from other banks. The Capital Local Area Bank has been transformed into a small finance bank w.e.f. April 24, 2016.

1.8 REGIONAL RURAL BANKS

Q32. Explain in detail about Regional Rural Banks.

Ans :

Rural banking institutions are playing a very important role for all-round development of rural areas of the country. In order to support the rural banking sector in recent years, Regional Rural Banks have been set up all over the country with the objective of meeting the credit needs of the most under privileged sections of the society.

History of RRBs

The Regional Rural Banks were setup on the basis of Narsimham Committee report (1975), by the legislations of the Regional Rural Banks Act of 1976. Thereafter, the **first Regional Rural Bank** was setup in 1975 itself by the name **Prathama Grameen Bank**.

Ownership of RRBs

The equity of RRBs is held by the stakeholders in fixed proportions of 50:15:35 distributed among the following.

- Central Government has 50% share.
- State Government has 15% share.
- The Sponsor Bank has 35% share.

These ratios are important to remember to be able to face the questions related to regional rural bank recruitment.

Features

1. RRBs have knowledge of rural constraints and problems like a cooperative because it operates in familiar rural environment.
2. RRBs show professionalism in mobilising financial resources like a commercial bank.
3. RRBs are supposed to work in its prescribed local limits.

4. It provides banking facilities as well as credit to small and marginal farmers, small entrepreneurs, labourers, artisans in rural areas.
5. RRBs have to fulfil the priority sector lending norms as applicable on other commercial banks.

The RRBs Act has made various provisions regarding the incorporation, regulation and working of RRBs. According to this Act, the RRBs are to be set-up mainly with a view to develop rural economy by providing credit facilities for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas.

Such facility is provided particularly to the small and marginal farmers, agricultural labourers, artisans, and small entrepreneurs and for other related matters.

Q33. What are the Objectives of RRBs ?

Ans :

The objectives of RRBs can be summarized as follows :

- i) To provide cheap and liberal credit facilities to small and marginal farmers, agriculture labourers, artisans, small entrepreneurs and other weaker sections.
- ii) To save the rural poor from the money lenders.
- iii) To act as a catalyst element and thereby accelerate the economic growth in the particular region.
- iv) To cultivate the banking habits among the rural people and mobilize savings for the economic development of rural areas.
- v) To increase employment opportunities by encouraging trade and commerce in rural areas.
- vi) To encourage entrepreneurship in rural areas.
- vii) To cater to the needs of the backward areas which are not covered by the other efforts of the Government?
- viii) To develop underdeveloped regions and thereby strive to remove economic disparity between regions.

Q34. What are the Problems Faced By Regional Rural Banks?

Ans :

The following were the main problems faced by the RRBs till recently.

i) Running into Losses

During 1997-98, out of 196 RRBs, 70 RRBs incurred losses amounting to Rs. 230.76 crore in total. The accumulated losses of all RRBs up to the end of March 1998 amount to Rs. 3116.00 crore.

This may be due to heavy overhead costs, reduction in lending rates, lower profit margins, heavy increase in salaries and allowances of staff, etc. During 2001-02, out of 196 RRBs, 167 made net profit of Rs. 699.93 crore while 29 suffered losses amounting to Rs. 92.05 crore. The accumulated losses of all RRBs declined to Rs. 2792.59 crore as on March, 2001.

ii) Slow Progress

The progress of RRBs is not up to the expectation and is slow when comparing with other types of banks because of many restrictions on their operations. For example till 1996, RRBs were permitted to lend only under priority sector schemes.

iii) Limited Scope of Investment

The basic objective of RRBs was to provide credit facilities to poor and weaker sections of society, i.e., to small and marginal farmers and other weaker sections. They were originally having limited scope to invest their surplus funds freely.

iv) Delay in Decision Making

The RRBs are controlled directly and indirectly by various agencies, i.e., the sponsoring bank, NABARD, RBI, besides Central Government. Thus, it takes long time to take decisions on some important issues. This, in turn affects the progress of RRBs. However, since end 1997, the operational responsibility of RRBs has been passed on to sponsor bank.

v) Lack of Co-ordination

Lack of co-ordination between the RRBs and sports or banks regarding branch expansion, policy making, etc., are also the important causes for the slow progress of RRBs.

vi) Difficulties in Deposit Mobilization

The RRBs are aiming at catering to the needs of poor and are not serving the needs of the rich. So, the RRBs are not able to attract the deposit from that potential sector.

vii) Lack of Training Facilities

Generally the staff of RRBs is urban-oriented and they may not know the problems and conditions of rural areas. Lack of training facility concerning these areas also affects the growth of RRBs.

viii) Poor recovery Rate

The recovery performance of the RRBs is not up to the mark. The rate of recovery in respect of many RRBs is around 55 per cent only.

ix) Capital Inadequacy

The capital adequacy is the very basis to financial soundness. There is capital inadequacy in RRBs as most of the RRBs have huge losses in their Balance Sheet eating away all the Capital of RRBs.

1.9 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

Q35. Define NABARD. Explain the functions of NABARD.

Ans :

National Bank for Agriculture and Rural Development (NABARD)

For promoting credit facilities to agriculture, small scale industries, cotton and village industries, handicrafts and other rural craft industries, NABARD came into existence after passing a bill in the parliament in July 12, 1982.

With the establishment of NABARD on July 12, 1982, the department of RBI engaged in

providing the agricultural finance, agricultural refinance and development corporation were controlled and managed by NABARD. As it is undertaking the agricultural related activities of RBI the assets and liabilities of the agricultural credit funds were transferred to NABARD. It is also responsible for managing the planning and development activities of RBI, refinance and development functions of the regional rural banks and so on. In March 1985, RBI disbursed ₹ 275 crores and ₹ 1200 on the long term operation and the national agricultural credit respectively. Net accretion to the resources of the NABARD in 2005-06 was, 6826 crores.

1. Capital was 500 crores initially
2. Subscribed and paid up capital 100 crores
3. It was raised to 2000 crores by 1999 - 2000.

Functions of NABARD

- a) It functions as an apex institution i.e., it takes up all the functions performed by the RBI with regard to rural credit. It attends to all the matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas.
- b) It serves as refinancing agency for the institutions providing production and investment credit of promoting various developmental activities in rural areas.
- c) It gives medium-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.
- d) It provides short-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.
- e) It extends medium-term and long-term credit of investment schemes in agriculture of State cooperative banks, Land development banks, Regional Rural Banks and commercial banks.
- f) It provides long-term loans to State Government to for subscribing to the share capital of cooperative institutions.

- g) It undertakes monitoring and evaluation of projects refinanced by it.
- h) It takes measures towards institution building for improving absorptive capacity of credit delivery system. These measures include monitoring, formulation of rehabilitation schemes, reconstruction of credit institutions and training of personnel etc.

Q36. Discuss the achievements of NABARD.

Ans :

NABARD is a single integrated organization which looks after the credit requirements of all types of agricultural and rural development activities. Its performance in extending various types of financial assistance is as follows :

a) Short-term Credit

It provides short-term credit facilities to state cooperative Banks for financing seasonal agricultural operations, marketing of crops, pisciculture activities, purchase and distribution of fertilizers, marketing activities etc.

b) Medium-term Credit

Medium term facilities are provided to StCBs and RRBs for converting short-term loans into medium-term loans.

c) Long-term Credit

Long term loans are granted to State Governments.

d) Assistance to Less Developed States

It has continued the policy of promoting agricultural investment in the less developed and under-banked states.

e) Assistance to Non-Farm Sector

It also provides financial help to non-form activities with a view to promote integrated rural development. Finance I provided for production and marketing activities of cooperative sugar mills, recognized cottage and small scale industries.

f) Rehabilitation Programme

It has started taking active part in organizing and strengthening the cooperative credit structure of the country. It has initiated a rehabilitation programme for financially and adminis-tratively weak Central and State Cooperative banks.

g) Assistance to Research and Development Projects

Every year, it provides financial assistance to a number of banks from its Research and Development Fund for setting up or strengthening their Technical, Monitoring and Evaluation cell.

h) Rural Infrastructure Development Fund

The Union Budget 1995-96 proposed creation of Rural Infrastructure fund in NABARD with a corpus of Rs. 2000 crore.

i) Kisan Credit Cards

It was introduced in 1998-99. They are issued to farmers by commercial banks, cooperative and RRBs. These cards enable the farmers to obtain credit. The limit of Rs. 5,000 was dispensed with. The loans disbursed under KCC scheme are insured by the General Insurance Corporation.

1.10 SIDBI

Q37. Discuss the objectives and functions of SIDBI ?

Ans :

Small Industries Development Bank of India (SIDBI) was established as wholly owned subsidiary of Industrial Development Bank of India (IDBI) under the Small Industries Development of India Act, 1989. It is the principal institution for promotion, financing and development of industries in the small scale sector. It also coordinates the function of institutions engaged in similar activities.

Objectives of SIDBI

- a) Initiating steps for technological upgradation and modernization of existing units
- b) Expanding the channels for marketing the products of the small scale sector
- c) Promotion of employment-oriented industries, especially in semi urban areas to create more employment opportunities and thereby checking migration of population to urban areas

Functions of SIDBI

- a) It refines loans and advances provided by the existing lending institutions to the small scale units.
- b) It discounts and rediscounts bills arising from sale of machinery to and manufactured by small scale industrial units.
- c) It extends financial support to State Small Industries Corporation for providing scarce raw materials to and marketing to and marketing the products of the small scale units.
- d) It provides services like factoring, leasing etc to small units.
- e) It extends financial support to State Small Industries Corporations for providing scarce raw materials to and marketing the products of the small scale units.
- f) It provides financial support to National Small Industries Corporation for providing, leasing, hire-purchase and marketing help to the small scale units

Capital of SIDBI

SIDBI started its operations from April 1990 with an initial authorized capital of Rs. 250 crore, which could be increased to Rs. 1000 crore. It also took over the outstanding portfolio of IDBI relating to small scale sector held under Small Industries Development Fund as on March 31, 1990 worth over Rs. 4000 crores.

1.11 DEVELOPMENT BANKS**Q38. Explain the features of development banks.**

Ans :

Development banks are those which have been set up mainly to provide infrastructure facilities for the industrial growth of the country. They provide financial assistance for both public and private sector industries.

Features of a Development Bank

Following are the main characteristic features of a development bank :

1. It is a specialised financial institution.
2. It provides medium and long term finance to business units.
3. Unlike commercial banks, it does not accept deposits from the public.
4. It is not just a term-lending institution. It is a multi-purpose financial institution.
5. It is essentially a development-oriented bank. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
6. It provides financial assistance not only to the private sector but also to the public sector undertakings.
7. It aims at promoting the saving and investment habit in the community.
8. It does not compete with the normal channels of finance, i.e., finance already made available by the banks and other conventional financial institutions. Its major role is of a gap-filler, i. e., to fill up the deficiencies of the existing financial facilities.
9. Its motive is to serve public interest rather than to make profits. It works in the general interest of the nation.

Q39. What are objectives of development banks?

Ans :

Development Banks are those financial institutions that provide funds and financial assistance to new and upcoming business enterprises. Development bank helps in According to Willian Diamond, "development bank is a financial institution to promote and finance enterprises in private sector."

Development banks like IDBI, SIDBI, and IFCI etc. were set up to meet long term and short term capital requirements of the industry. Development banks coordinate the activities of those institutions, engaged in financing, promoting and developing industries. They help in accelerating industrial and economic growth.

The following are the objectives of development banks:

1. Rapid Industrial growth

Industrial sector is the dynamic sector of the Indian economy. This sector contributes to the generation of employment and income in the country. Funds are provided by the development banks to start a new business venture, expansion and diversification of the business in new sector etc.

These funds are utilised to achieve several objectives that leads to accelerate industries and economic growth. Development banking supports the programmes of industrialisation of the country, by promoting entrepreneurial activities.

2. Encouraging entrepreneurs

Industrialisation helps in curbing economic and social problems thereby making economies progress. Emerging entrepreneurs

are encouraged to give shape to their ideas. Development bank helps those entrepreneurs by providing funds for commencing new business.

Government has recognised the importance of entrepreneurs in the industrial development and thus providing number of facilities and incentives to motivate them for undertaking industrial projects.

3. Balanced regional development

There has been always an issue related to regional disparities. Development bank helps in curbing these regional disparities by providing funds to the entrepreneurs at low rate of interest if the organisation is planned in the backward areas. This would lead to the development of all areas thereby making balanced regional development.

4. Filling gaps

It is not possible for the commercial banks to fulfill all financial needs of all the customers. Absence of organised capital market, absence of adequate facilities for financing industries arise the problem of slow development of industrialisation. Such development banks can fulfill the credit gap. They provide long- term funds for industries where gestation period may be longer.

5. Helps government

Government formulates financial policies with the help of development banks. They also help in implementing these policies. For example, NABARD bank is set up as an apex development bank for extending support to the rural areas. It helps the government in matters relating to the rural development, offers training and research facilities for banks working in the field of rural development, and acts as a regulator for co-operative banks and RRB's.

Q40. What are the Functions of Development Banks.

Ans :

1. Small Scale Industries (SSI)

Development banks play an important role in the promotion and development of the small-scale sector. Government of India (GOI) started Small Industries Development Bank of India (SIDBI) to provide medium and long-term loans to Small Scale Industries (SSI) units. SIDBI provides direct project finance, and equipment finance to SSI units. It also refines banks and financial institutions that provide seed capital, equipment finance, etc., to SSI units.

2. Development of Housing Sector

Development banks provide finance for the development of the housing sector. GOI started the National Housing Bank (NHB) in 1988.

NHB promotes the housing sector in the following ways:

1. It promotes and develops housing and financial institutions.
2. It refines banks and financial institutions that provide credit to the housing sector.
3. Large Scale Industries (LSI)

Development banks promote and develop large-scale industries (LSI). Development financial institutions like IDBI, IFCI, etc., provide medium and long-term finance to the corporate sector. They provide merchant banking services, such as preparing project reports, doing feasibility studies, advising on location of a project, and so on.

4. Agriculture and Rural Development

Development banks like National Bank for Agriculture & Rural Development (NABARD) helps in the development of agriculture. NABARD started in 1982 to provide refinance

to banks, which provide credit to the agriculture sector and also for rural development activities. It coordinates the working of all financial institutions that provide credit to agriculture and rural development. It also provides training to agricultural banks and helps to conduct agricultural research.

5. Enhance Foreign Trade

Development banks help to promote foreign trade. Government of India started Export-Import Bank of India (EXIM Bank) in 1982 to provide medium and long-term loans to exporters and importers from India. It provides Overseas Buyers Credit to buy Indian capital goods. It also encourages abroad banks to provide finance to the buyers in their country to buy capital goods from India.

6. Review of Sick Units

Development banks help to revive (cure) sick-units. Government of India (GOI) started Industrial Investment Bank of India (IIBI) to help sick units.

IIBI is the main credit and reconstruction institution for revival of sick units. It facilitates modernization, restructuring and diversification of sick-units by providing credit and other services.

7. Entrepreneurship Development

Many development banks facilitate entrepreneurship development. NABARD, State Industrial Development Banks and State Finance Corporations provide training to entrepreneurs in developing leadership and business management skills. They conduct seminars and workshops for the benefit of entrepreneurs.

8. Regional Development

Development banks facilitate rural and regional development. They provide finance for starting companies in backward areas. They also help the companies in project management in such less-developed areas.

9. Contribution to Capital Markets

Development banks contribute the growth of capital markets. They invest in equity shares and debentures of various companies listed in India. They also invest in mutual funds and facilitate the growth of capital markets in India.

Q41. Discuss the Development Banks in India.

Ans :

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 Bank of India (IDBI), 1964
4. State Finance Corporation (SFC), 1951
5. Small Industries Development Bank of India (SIDBI), 1990
6. Export Import Bank (EXIM)
7. Small Industries Development Corporation (SIDCO)
8. National Bank for Agriculture and Rural Development (NABARD).

In addition to these institutions, there are also institutions such as Life Insurance Corporation of India, General Insurance Corporation of India, National Housing Bank, Unit Trust of India, etc., which are providing investment funds.

1.11.1 IFCI**Q42. Explain the composition of IFCI.**

Ans :

IFCI was established as a statutory corporation on 1st July 1948 by a special Act of Parliament, IFCI Act, 1948. It was converted into a public limited company on July 1, 1993. Its main object is to provide medium and long term credit to eligible industrial concerns in corporate sectors of the economy, particularly to those industries to which banking facilities are not available.

Objectives

The primary role of IFCI is to provide 'direct financial assistance' on medium and long term basis to industrial projects in the corporate and co-operative sectors. Over the years, the scope of activities of the corporation has widened. The objectives of the corporation are stated below.

- a) To provide long and medium-term credit to industrial concerns engaged in manufacturing, mining, shipping and electricity generation and distribution.
- b) The period of credit can be as long as 25 years and should not exceed that period.
- c) To grant credit to a single concern up to a maximum amount of rupees one crore. This limit can be exceeded with the permission of the government under certain circumstances.
- d) Guarantee loans and deferred payments.
- e) Underwrite and directly subscribe to shares and debentures issued by companies.
- f) Assist in setting up new projects as well as in modernisation of existing industrial concerns in medium and large scale sector.
- g) Assist projects under co-operatives and in backward areas.

Functions

The main functions of IFCI are as under :

- i) Granting loans and advances for the establishment, expansion, diversification and modernisation of industries in corporate and co-operative sectors.

- ii) Guaranteeing loans raised by industrial concerns in the capital market, both in rupees and foreign currencies.
- iii) Subscribing or underwriting the issue of shares and debentures by industries. Such investment can be held up to 7 years.
- iv) Guaranteeing credit purchase of capital goods, imported as well as purchased within the country.
- v) Providing assistance, under the soft loans scheme, to selected industries such as cement, cotton textiles, jute, engineering goods, etc.
- vi) Providing technical, legal, marketing and administrative assistance to any industrial concern for the promotion, management and expansion of the industrial concern.
- vii) Providing equipment (imported or indigenous) to the existing industrial concerns on lease under its 'equipment leasing scheme'.
- viii) Procuring and reselling equipment to eligible existing industrial concerns in corporate or co-operative sectors.
- ix) Rendering merchant banking services to industrial concerns. In 1995-96, 67% of the total financial assistance distributed by IFCI was in the form of rupee term loans, while foreign currency loans accounted for approximately 17% of total financial assistance. Thus the two types of assistance accounted for a total of 84% of the total financial assistance by IFCI. The remaining 16% of financial assistance, was in the form of underwriting, direct subscription, guarantees and equipment leasing.

1.11.2 SFC

Q43. What are the objectives and functions of SFC.

Ans :

IFCI was established to cater to the financial needs of industrial concerns in large scale corporate and co-operative sectors. Small and medium sized enterprises were outside the purview of IFCI. To

meet the financial needs of small and medium enterprises, the government of India passed the State Financial Corporation Act in 1951, empowering the State governments to establish development banks for their respective regions.

Under the Act, SFCs have been established by State governments to meet the financial requirements of medium and small sized enterprises. There are 18 SFCs at present.

Objectives

The objectives of state financial corporations are as under :

1. Provide financial assistance to small and medium industrial concerns. These may be from corporate or co-operative sectors as in case of IFCI or may be partnership, individual or joint Hindu family business. Under SFCs Act, "industrial concern" means any concern engaged not only in the manufacture, preservation or processing of goods, but also mining, hotel industry, transport undertakings, generation or distribution of electricity, repairs and maintenance of machinery, setting up or development of an industrial area or industrial estate, etc.
2. Provide long and medium-term loan repayable ordinarily within a period not exceeding 20 years.
3. Grant financial assistance to any single industrial concern under corporate or co-operative sector with an aggregate upper limit of rupees Sixty lakhs. In any other case (partnership, sole proprietorship or joint Hindu family) the upper limit is rupees Thirty lakhs.
4. Provide Financial assistance generally to those industrial concerns whose paid up share capital and free reserves do not exceed Rs. 3 crore.
5. To lay special emphasis on the development of backward areas and small scale industries.

Functions of State Financial Corporation (SFCs)

The functions of SFCs include :

1. Grant of loans and advances to or subscribe to debentures of, industrial concerns repayable within a period not exceeding 20 years, with option of conversion into shares or stock of the industrial concern.
2. Guaranteeing loans raised by industrial concerns which are repayable within a period not exceeding 20 years.
3. Guaranteeing deferred payments due from an industrial concern for purchase of capital goods in India.
4. Underwriting of the issue of stock, shares, bonds or debentures by industrial concerns.
5. Subscribing to, or purchasing of, the stock, shares, bonds or debentures of an industrial concern subject to a maximum of 30 percent of the subscribed capital, or 30 percent of paid up share capital and free reserve, whichever is less.
6. Act as agent of the Central government, State government, IDBI, IFCI or any other financial institution in the matter of grant of loan or business of IDBI, IFCI or financial institution.
7. Providing technical and administrative assistance to any industrial concern or any person for the promotion, management or expansion of any industry.
8. Planning and assisting in the promotion and development of industries.

- a) It should be a small-scale industry according to the governments latest updation.
 - b) The list of items banned by the government should not be manufactured by these units.
 - c) The undertaking should hold the statutory license for establishing the company.
 - d) The proprietor or owner of the unit should prove his/her ability to manufacture and sell the goods and services.
 - e) The project initiated by the entrepreneurs should be technically feasible and economically viable.
2. The bank and financial institution also help in guiding how to prepare statement or scheme/project.
 3. Banks also extend consultant and advisory services to their clients for which it does not levy any charges for the services rendered.

Export Import Bank of India (EXIM)

The EXIM was established in the year 1982 on 1st January under the Act of parliament as the principal financial institution for promoting and financing international trade of India. The EXIM bank provides financial assistance to both exporters and importers for production and sale of goods and services.

The exporter can avail the facilities such as supplier's credit, export product development loans, bulk import finance, loans for export marketing. The bank also offers export bills rediscounting facility and refinance of term loans and guarantees the projects.

Besides the above assistance the EXIM bank promotes exports by advising and providing informative services on merchant banking country risk analysis, procedures of multilateral institutions etc., to the exporters.

The EXIM bank has 23 major programmes for its customers like, Indian exporters, foreign entities and commercial banks.

1.11.3 EXIM

Q44. Explain briefly about EXIM bank?

Ans :

Role of Banks/Financial Institutions

The banks and financial institution have been playing a predominant role in the promotion and development of small-scale industries since 1956.

1. Eligibility Criteria

In order to avail the assistance from the bank or financial institution the small scale units and others should satisfy the following conditions,

1.11.4 LIC**Q45. Explain the composition of LIC.**

Ans :

Life Insurance Corporation of India (LIC)

The LIC of India was setup under the LIC Act, 1956, as the wholly-owned corporation of India. After the nationalisation of the life insurance business it was taken over by the government from the private players.

The primary objective of LIC is to do business and mobilise the funds to provide social security to the individuals, rural and urban group etc.

The committee due to reforms in the insurance sector have suggested that foreign companies should be allowed to conduct life insurance business in the form of joint venture with the Indian companies.'

In the investment policy of LIC about 75% of the funds have to be invested in government securities (Central and State government) and including government guaranteed marketable securities in the form of shares, bonds and debentures.

Life insurance corporation of India extends loans for,

1. Improvement of socially-oriented sectors.
2. Providing infrastructure facilities like housing, electricity, water supply.
3. Financial assistance is provided to the corporates in the form of term loans and Subscription to shares and debentures.

1.11.5 UTI**Q46. Discuss the objectives and functions of UTI.**

Ans :

Unit Trust of India (UTI)

The UTI was created by an Act of parliament in the year 1964. The UTI mobilizes the savings of small investors and channelises them into business/ corporate investments. The UTI provides assistance by granting term loans, underwriting and subscription of shares and debentures.

The outlay of finance in the year 1994-95 provided by UTI to the corporate sector was Rs. 7,677 crore. Mainly the finance was intended for developing new projects and for expansion and modernisation of business units and meeting the working capital requirements of industrial units.)

Objectives

The main objectives of UTI are as under

- i) To encourage savings of people belonging to middle and low income groups.
- ii) To mobilise savings from the small savers.
- iii) To channelise savings to industrial growth.
- iv) To allow investors to participate in the prosperity of the industries.

Functions

The main functions of UTI are as follows :

- i) To mobilise the savings of the community through sale of units.
- ii) To invest the savings so mobilised in corporate securities such as shares and debentures, etc.
- iii) To serve unit holders along the length and breadth of the country.
- iv) To underwrite the issue of shares and debentures.

Short Question and Answers

1. Define the term bank.

Ans :

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 of a Bank

- (i) **According to Oxford Dictionary** defines a bank as “an establishment for custody of money, which it pays out on customer’s order.”
- (ii) **According to Section 5(1) (b) of the Banking Regulation Act, 1949** defines **banking** as, “The accepting for the purpose of lending or investment, of deposits from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise”.
- (iii) **According to Section 5(1) (c) defines a banking company** as, “Any company which transacts the business of banking in India”.

2. Commercial Banks.

Ans :

Commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation, and agency functions. They are also called joint stock banks because they are organized in the same manner as joint stock companies. They usually advance short-term loans to customers. Now, they have started giving medium-term and long-term loans also. In India 20 major commercial banks have been nationalized, whereas in developed countries they are run like joint stock companies in the private sector. Some of the commercial banks in India are Andhra Bank, Canara Bank, Indian Bank, Punjab National Bank, etc.

Definition

- (i) **According to Crowther**, “A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it”.
- (ii) **According to Prof. Sayers**, “An institution whose debts (bank deposits) are widely accepted in settlement of other people’s debts to each other”.
- (iii) **According to Prof. Kinley**, “A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use”.
- (iv) **Indian Companies Act, 1949**, has defined the bank, “The accepting for the purpose of lending or investment of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise”.

3. E-Banking

Ans :

Net Banking, E-Banking, Online banking or Internet Banking means any user with a personal computer and a browser can get connected to his bank’s website to perform any of the virtual banking functions.

- In internet banking system the bank has a centralized database that is web-enabled.
- All the services that the bank has permitted on the internet are displayed in menu. Any service can be selected and further interaction is dictated by the nature of service.
- The traditional branch model of bank is now giving place to an alternative delivery channels with ATM network. Once the branch offices of bank are interconnected through terrestrial or satellite links, there would be no physical identity for any branch.
- It would be a borderless entity permitting anytime, anywhere and anyhow banking.

- The network which connects the various locations and gives connectivity to the central office within the organization is called intranet.
- These networks are limited to organizations for which they are set up.

4. Disadvantages of internet banking.

Ans :

The disadvantages of internet banking are as follows:

1) Time Taking

In order to register for bank's online program, people will probably have to provide ID and sign a form at a bank branch. If they and their spouse wish to view and manage their assets together online, one of them may have to sign a durable power of attorney before the bank will display all of their holdings together.

2) Learning Curve

Banking sites can be difficult to navigate at first. Plan to invest some time and/or read the tutorials in order to become comfortable in virtual lobby.

3) Bank Site Changes

Even the largest banks periodically upgrade the online programs, adding new features in unfamiliar places. In some cases, people may have to re-enter account information.

4) Trust Aspect

For many people, the biggest hurdle to online banking is learning to trust it. Internet banking should be entered very carefully if people wish to enjoy their financial life.

5. M-Banking.

Ans :

Mobile banking (also known as M-Banking, SMS banking, etc.) is a term used for performing balance checks, account transactions, payments, etc., via a mobile device such as a mobile phone.

- Mobile banking today is most often performed via SMS or the Mobile Internet but can also use special programs called clients downloaded to the mobile device.

- Mobile Banking is the hottest area of development in the banking sector and is expected to replace the credit/debit card system in future.

- In past two years, mobile banking users have increased three times if it is compared with the use of either debit card or credit card. Moreover 85-90% mobile users do not own credit cards.

- Mobile banking uses the same infrastructure like the ATM solution.

- But it is extremely easy and inexpensive to implement.

- It reduces the cost of operation for bankers in comparison to the use of ATMs.

Mobile banking is defined as "Mobile Banking refers to provision and availment of banking and financial services with the help of mobile telecommunication devices. The scope of offered services may include facilities to conduct bank and stock market transactions, to administer accounts and to access customized information".

6. Advantages of Mobile Banking.

Ans :

Following are the advantages of mobile banking:

- 1) It utilizes the mobile connectivity of telecom operators and therefore does not require an internet connection.
- 2) With mobile banking, users of mobile phones can perform several financial functions conveniently and securely from their mobile.
- 3) People can check their account balance, review recent transaction, transfer funds, pay bills, locate ATMs, deposit cheques, manage investments, etc.
- 4) Mobile banking is available round the clock 24/7/365, it is easy and convenient and an ideal choice for accessing financial services for most mobile phone owners in the rural areas.
- 5) Mobile banking is said to be even more secure than online/internet banking.

7. What is core banking?**Ans :**

Core banking is normally defined as the business conducted by a banking institution with its retail and small business customers. Many banks treat the retail customers as their core banking customers and have a separate line of business to manage small business. Larger business is handled by the corporate banking division of the institution. Core banking basically is depositing and lending of money.

Now a days, most banks use core banking applications to support their operations where 'CORE' stands for "Centralized Online Real-time Environment". This basically means that all the bank's branches access applications from centralized data centres. It means that the deposits made are reflected immediately on the servers of bank and the customer can withdraw the deposited money from any of the branches of bank throughout the world. These applications now also have the capability to address the needs of corporate customers providing a comprehensive banking solution. Normal core banking functions will include deposit accounts, loans, mortgages and payments. Banks make these services available across multiple channels like ATMs, internet banking and branches.

8. Bancassurance.**Ans :**

Bancassurance as an alternative distribution channel was identified as a source of improving the non-interest income of banks. The government authorities have played an active role in bancassurance implementation in an effort to keep abreast with world financial markets. Since banking services, insurance setting and fund management are all interrelated activities and have inherent synergies, selling of insurance by banks would be mutually beneficial for both banks and insurance companies.

Bancassurance, in its simplest form, is distribution of insurance products through a bank's branch network. Hence, there is a room for bancassurance where banking and insurance congregate with each other. It is a service that can

fulfill both banking and insurance needs at the same time. Bancassurance as a concept first began in India when the insurance industry opened up to private participation in December 1999.

Bancassurance simply means selling of insurance products by banks. In this arrangement, insurance companies and banks undergo a tie-up, thereby allowing banks to sell the insurance products to its customers. This is a system in which a bank has a corporate agency with one insurance company to sell its products. By selling insurance policies bank earns a revenue stream apart from interest. It is called as fee-based income. This income is purely risk free for the bank since the bank simply plays the role of an intermediary for sourcing business to the insurance company.

9. Whao is a banking ombudsman?**Ans :**

Banking ombudsman refers to a person appointed by the Reserve Bank of India to redress consumer complaints against any bank in India. Thus it can be said that a banking ombudsman acts as an official judge and grievance redresser who is entrusted with the responsibility of redressing the complaints of the banking customers.

The banking ombudsman is appointed by the Reserve Bank of India in accordance with the Banking Ombudsman Scheme, which was first introduced in the year 1995. This scheme was later revised in the year 2002 and again in the year 2006.

The banking ombudsman is a Quasi judicial authority and has the power to order both the parties (i.e., bank and customer) to complain. At present, in India 15 banking ombudsman had been appointed and they are located in major state capitals across the country.

10. RBI.**Ans :****Introduction**

The **Reserve Bank of India (RBI)** is the apex financial institution of the country's financial system. It is entrusted with the task of control, supervision, promotion, development and planning.

The Reserve Bank of India influences the management of commercial banks through its

various policies, directions and regulations. Its role in bank management is quite unique. It performs the four basic functions such as planning, organizing, directing and controlling in laying a strong foundation for the functioning of commercial banks.

The Reserve Bank of India is India's central bank. It came into existence on 1st April 1935 under the Reserve Bank of India Act, 1934.

History of Reserve Bank of India (RBI)

In 1921, the Imperial Bank of India was established to perform as central bank of India by the British Government. But unfortunately Imperial Bank failed to show its performance up to the mark and didn't achieve any success as the Central Bank. Then the Government asked the Hilton Young Commission in 1925 to view on this subject.

The commission submitted their reports saying that one single organization can't be able to act as two separate agencies (both credit and currency control). So, it's required to set up a brand new central bank. In 1st April 1935, Reserve Bank of India was set up. In January, 1949, RBI was nationalized.

11. Define monetary policy.

Ans :

Meaning

The term monetary policy is also known as the 'credit policy' or called 'RBI's money management policy' in India. How much should be the supply of money in the economy? How much should be the ratio of interest? How much should be the viability of money? etc. Such questions are considered in the monetary policy. From the name itself it is understood that it is related to the demand and the supply of money.

Definitions

Many economists have given various definitions of monetary policy. Some prominent definitions are as follows.

- i) **According to Prof. Harry Johnson**, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

- ii) **According to A.G. Hart**, "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

12. District Central Co-operative Bank

Ans :

District Central co-operative Bank (DCCB) refers to a network of co-operative banking established by the government of India for the purpose of providing banking facilities in the rural and semi-rural areas of India. The main objective of this bank is providing agricultural loans, consumer banking, co-operate banking, mortgage loans etc in rural and semi rural areas in every district of India. The district co-operative central bank is popularly called as DCC bank.

As the DCC bank is located in every district in every state of India these fore, it is formed on the name of the district where it is located. For example, the DCC bank located in Hyderabad district would be named as "Hyderabad DCC Bank". The directors and members consist of rural workforce including rural co-operatives, milk unions, agricultural and non- agricultural co-operatives and so on. All the DDC banks located in a particular state are headed by the state apex central co-operative bank, which is generally located in the capital of every state. Thus, the hierarchy of the DCC Banks is made to ensure that rural consumers get easy access to these banks.

13. Regional Rural Banks.

Ans :

Rural banking institutions are playing a very important role for all-round development of rural areas of the country. In order to support the rural

banking sector in recent years, Regional Rural Banks have been set up all over the country with the objective of meeting the credit needs of the most under privileged sections of the society.

History of RRBs

The Regional Rural Banks were setup on the basis of Narsimham Committee report (1975), by the legislations of the Regional Rural Banks Act of 1976. Thereafter, the **first Regional Rural Bank** was setup in 1975 itself by the name **Prathama Grameen Bank**.

Ownership of RRBs

The equity of RRBs is held by the stakeholders in fixed proportions of 50:15:35 distributed among the following.

- Central Government has 50% share.
- State Government has 15% share.
- The Sponsor Bank has 35% share.

These ratios are important to remember to be able to face the questions related to regional rural bank recruitment.

14. What are the Objectives of RRBs ?

Ans :

The objectives of RRBs can be summarized as follows :

- i) To provide cheap and liberal credit facilities to small and marginal farmers, agriculture labourers, artisans, small entrepreneurs and other weaker sections.
- ii) To save the rural poor from the money lenders.
- iii) To act as a catalyst element and thereby accelerate the economic growth in the particular region.
- iv) To cultivate the banking habits among the rural people and mobilize savings for the economic development of rural areas.
- v) To increase employment opportunities by encouraging trade and commerce in rural areas.

- vi) To encourage entrepreneurship in rural areas.
- vii) To cater to the needs of the backward areas which are not covered by the other efforts of the Government?
- viii) To develop underdeveloped regions and thereby strive to remove economic disparity between regions.

15. Functions of NABARD.

Ans :

- a) It functions as an apex institution i.e., it takes up all the functions performed by the RBI with regard to rural credit. It attends to all the matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas.
- b) It serves as refinancing agency for the institutions providing production and investment credit of promoting various developmental activities in rural areas.
- c) It gives medium-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.
- d) It provides short-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.
- e) It extends medium-term and long-term credit of investment schemes in agriculture of State cooperative banks, Land development banks, Regional Rural Banks and commercial banks.
- f) It provides long-term loans to State Government to for subscribing to the share capital of cooperative institutions.

16. Features of a Development Bank.

Ans :

Following are the main characteristic features of a development bank :

1. It is a specialised financial institution.
2. It provides medium and long term finance to business units.
3. Unlike commercial banks, it does not accept deposits from the public.
4. It is not just a term-lending institution. It is a multi-purpose financial institution.
5. It is essentially a development-oriented bank. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
6. It provides financial assistance not only to the private sector but also to the public sector undertakings.
7. It aims at promoting the saving and investment habit in the community.

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Choose the Correct Answer

1. _____ is a market for long-term funds (or) securities with a maturity period of above one year. [a]
(a) Capital market (b) Secondary market
(c) Money market (d) Primary market
2. _____ is a financial intermediary that pools the savings of investors and invests into a diversified portfolio of securities. [b]
(a) Commercial Bank (b) Mutual funds
(c) Insurance Companies (d) None
3. Commercial banks perform four major functions. They are Traditional functions, Incidental functions, Core functions and _____. [a]
(a) Ancillary functions (b) Letter of credit
(c) Promotional functions (d) All
4. To control the liquidity risk through fundamental approach two methods are used. They are: Asset management _____. [c]
(a) Technical management (b) Deposits
(c) Liability management (d) None
5. Simulation method is one of the techniques used to measure _____. [d]
(a) Liquidity risk (b) Foreign exchange risk
(c) Credit risk (d) ALM Interest Rate Risk
6. _____ affects the incomes/expenses, value of assets/liabilities, and the market value. [c]
(a) Reinvestment risk (b) Basis risk
(c) Real interest rate risk (d) Call/Put risk
7. Advantage of branch banking [d]
(a) large scale operation (b) large financial resources
(c) increase in banking facilities (d) all
8. _____ is the default risk wherein, any one party involved in the contract with other party fails to meet his financial obligations. [d]
(a) Liquidity risk (b) Contingency risk
(c) Volatility risk (d) Credit risk
9. When a mismatch exists between the benchmark rates, _____ take place/occurs. [c]
(a) Call/Put risk (b) Credit risk
(c) Basis risk (d) Prepayment risk
10. Advantage of e-banking [d]
(a) transfer services (b) quality service
(c) ease of monetary (d) all

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Fill in the blanks

1. A _____ is a financial institution which deals with deposits and advances and other related services.
2. The state bank of India was introduced on _____ .
3. Banks also perform certain _____ functions for and on behalf of their customers.
4. _____ is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services.
5. NEFT Stands for _____ .
6. RTGS Stands for _____ .
7. SMS Stands for _____ .
8. _____ simply means selling of insurance products by banks.
9. The term monetary policy is also known as the _____ .
10. SIDBI stands for _____ .
11. 'Offering trust services' is one of the _____ services offered by banks.
12. Selling retirement plans is one of the modern services offered by _____.
13. The various sources of funds for banks are equity, reserves and _____.
14. The function of note issue is maintained through two departments, viz., _____ Department and _____ Department.
15. All the activities of the Agricultural Credit Department are now transferred to _____.
16. _____ acts as the sole agent of RBI where it has no branch.
17. A bill market is a market for _____ bills.
18. _____ is the period for which the ways and means advances are granted to Central and State governments.
19. Objective of Monetary policy is _____.
20. A _____ is a federation of primary credit societies.
21. The main function of NABARD is to provide _____ to cooperative banks and RRBs.
22. An asset which ceased to yield income is called _____ .
23. A general provision of _____ % of the outstanding is required for sub-standard assets.
24. Type of co-operative bank _____ .
25. Example of contemporary bank _____ .

26. RRBs stands for _____ .
27. Type of Development Bank _____ .
28. Function of Development Banks _____ .
29. Establishment of IDBI in _____ .

ANSWERS

1. bank
2. July 1,1955.
3. agency
4. Debit card
5. National Electronic Fund Transfer
6. Real Time Gross Settlement Sytstem
7. Short Message Service
8. Bancassurance
9. credit policy
10. Small Industries Development Bank
11. Traditional services
12. Banks
13. Borrowings
14. Issue-Banking,
15. NABARD,
16. SBI,
17. Short-term.
18. 3 months
19. Economic Growth
20. Central Cooperative Bank,
21. Refinance facilities,
22. Non-performing assets,
23. 10%.
24. District Central Co-operative Bank
25. Payment banks
26. Regional Rural Banks
27. IDBI
28. Enhance Foregin Trade
29. 1964

UNIT II

Banker and Customer Relationship:

Definition of Banker and Customer - Relationship Between Banker and Customer
- KYC norms - General and Special Features of Relationship - Opening of Accounts
- Special Types of Customers Like Minor, Married Women, Partnership Firms, Companies, Clubs and other Non-Trading Institutions.

2.1 DEFINITION OF BANKER AND CUSTOMER

Q1. Define the term banker and customer.

Ans :

i) Meaning of a Banker

Services provided by today's bankers are far from their traditional activities of merely receiving deposits, honouring cheques, and granting loans.

- The modern day banker issue credit and charge cards, deals in diverse foreign exchange and money market transactions, telegraphic and electronic transfers, bills and trade finance facilities, share financing, custodian, and trust businesses and provides a variety of other banking and investment services.
- Indeed, it is now quite difficult to define the word 'banker' or 'bank' to cover all their diverse and varied activities and functions.
- Essentially, there are two reasons why one needs to know who a banker is.
- First, the nature of the relationship between bank and customer has certain characteristics which may, to some degree, distinguish it from other relationships.
- Secondly, a variety of statutes refer to banks, or to bankers, or to the business of banking.
- A banker is a dealer in capital or more properly a dealer in money. He is an intermediate party between the borrower and the lender. He borrows from one party and lends to another.

- Section 3 of the Negotiable Instruments Act says that the term 'banker' includes any person acting as a banker.

Definitions

- i) **According to Dr. Herbert Hart**, "A banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current account".
- ii) **According to Halsbury**, "A banker is an individual, partnership, or corporation whose sole predominating business is banking, that is the receipt of money on current account or deposit account and the payment of cheques drawn by and the collection of cheques paid in by a customer".
- iii) **According to Justice Homes**, "The real business of a banker is to obtain deposits of money which he may use for his own profit by lending it out again".

To sum up a banker is who,

- 1) Take deposit account.
- 2) Take current accounts.
- 3) Issue and pay cheques.
- 4) Collect cheques crossed and uncrossed for his customers.

Money lender is not considered as a banker as mere lending does not constitute banking business. Banker is an institution which borrows money by accepting deposits from the public for the purpose of lending to those who are in need of money.

ii) Meaning of a Customer

The term 'customer' of a bank is not defined by law. In the ordinary language, a person who has an account in a bank is considered its customer.

"A customer is a person who has some sort of account, either deposit or current or some similar relation with a bank and from this it follows that any person could become a customer by opening a deposit or current account or having some similar relation with a bank".

In *Central Bank of India versus Gopinathan Nair*, the Kerala High Court stated, "a customer is a person who has the habit of resorting to the same place or person to do a business".

In order to constitute a person as a customer, he must satisfy the following conditions:

- 1) He must have an account with the bank - i.e., saving bank account, current deposit account, or fixed deposit account.
- 2) The transactions between the banker and the customer should be of banking nature, i.e., a person who approaches the banker for operating Safe Deposit Locker or purchasing travelers cheques is not a customer of the bank since such transactions do not come under the orbit of banking transactions.
- 3) Frequency of transactions is not quite necessary though anticipated.

2.2 RELATIONSHIP BETWEEN BANKER AND CUSTOMER**2.2.1 General and Special Features of Relationship**

Q2. State the Relationship Between Banker and Customer.

(or)

Explain the relationship between banker and customer.

Ans :

The relationship between the banker and the customer arises out of the contract entered in between them. This contract is created by mutual consent. A contract that exists between a bank and its customer is a loan contract. This is because if the customers account is in credit, the bank owes him that money and vice versa, if the account is overdrawn.

This contractual relationship between banker and customer is regulated by the rules contained in the Negotiable Instruments Act, 1881 and the Indian Contract Act, 1872. The relationship between the banker and the customer is vital. The relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account.

Types of Relationship between Bank and Customer

This relationship is of two types which are as follows:

- 1) General relationship between banker and customer.
- 2) Special relationship between banker and customer.

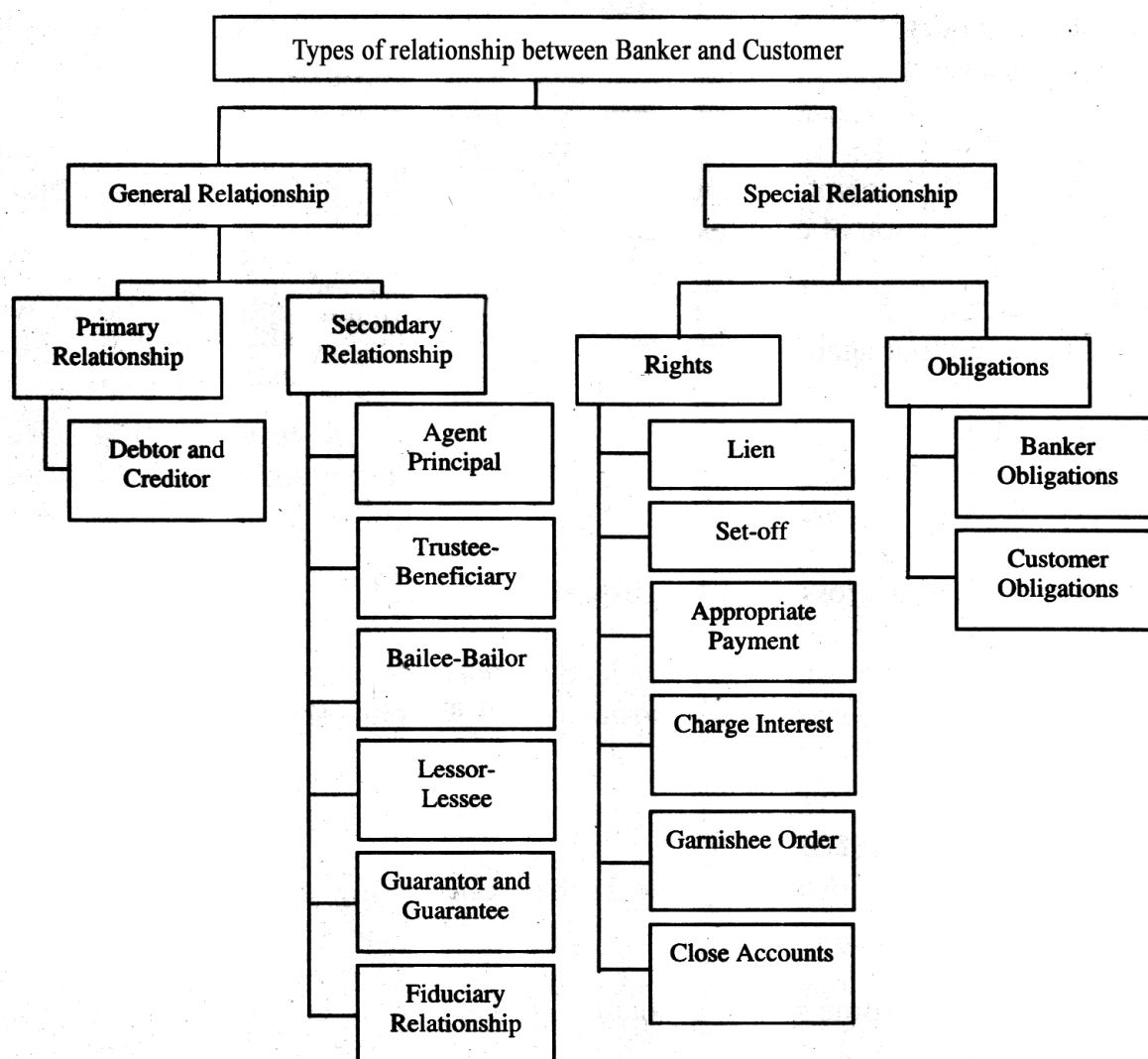
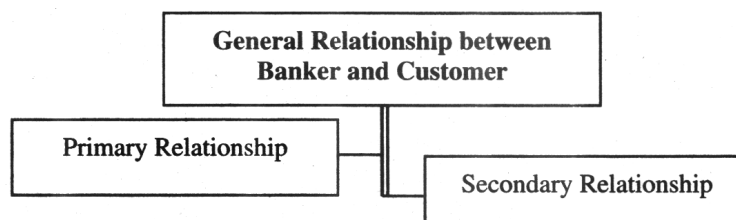


Fig. Relationship between Banker and Customer

1) General Relationship between Banker & Customer

The general relationship between banker and customer are describes into two forms:



A) Primary Relationship

Primary relationship is in the form of a 'Debtor' which arises out of a contract between the banker and customer. Banker is neither a bailee nor a trustee nor an agent but only a debtor. Thus, the fundamental relationship is that of "Debtor and Creditor".

Relation of Debtor and Creditor

The true relationship between a banker and his customer is that of a debtor and a creditor.

According to Sir John Paget, "The relation of banker and customer is primarily that of a debtor and creditor, the respective positions being determined by the existing state of the account. Instead of money being set apart in the safe room, it is replaced by a debt due from the banker. The money deposited with him becomes his property and is absolutely at his disposal". As long as the customer's account shows a credit balance, the banker would be a debtor and in case the customer's account shows a debit balance, the hanker would be creditor.

These are following essentials of debtor-creditor relationship:

1) Creditor must Demand Payment

Although the banker is a debtor and the customer is creditor, it is not at all necessary for the debtor to go to the creditor to pay the amount. This is normally expected in case of commercial transactions where in there are two parties one a debtor and the other a creditor, i.e., ordinary debtor-creditor relationship. But, here in case of banker and customer relationship, though the banker is a debtor, he is not expected to approach the creditor for settlement of dues. Here, the relationship is different and has a special feature, namely, demand is necessary from the customer.

2) Proper Place and Time of Demand

The demand by the creditor must be made at the proper place and in proper time. It means that the customer should present the cheque for payment at that place of the bank where the customer's account is maintained. It is quite clear that at other places, the customers of the state of his account are not known. It is also essential that the customers should demand payment on a working day, i.e., not on a holiday or a day which is closed for public. And in addition, it must be presented during business hours, i.e., it should not be presented either before or after the business hours.

3) Demand must be made in Proper Form

The demand made by the customer must be in the prescribed form as required by the bank. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the bankers. Otherwise the banker has every right to refuse payment.

B) Secondary Relationship

It consists of

1) Agent-Principal

A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. These are as follows:

- i) Purchasing or selling of securities,
- ii) Collection of income,
- iii) Making periodical payments as instructed by his customers,
- iv) Collecting interest and dividend on securities lodged by his customers,
- v) Receiving safe custody valuables and securities lodged by his customers,
- vi) Collecting cheques, hundies, drafts of the customers.

In this case, the banker and customer relationship is, in the form of an 'Agent' and 'Principal'.

2) Trustee-Beneficiary

Banks may also act as trustee. The position of a bank will be that of a trustee when:

- i) A person having no account with a bank, deposit the money with instruction to retain it till further instruction.
- ii) The customer instructs a bank to debit his account or deposit an amount for utilizing it for a specific purpose or for remitting to other branch/bank. (But in absence of specific instruction, this relationship will not be established.)
- iii) Manages properties of its customer.

3) Bailee-Bailor

- Section 2 of the Indian Contract Act defines that bailment as the delivery of goods by one person to another for some purpose upon a contract that they shall, when the purpose is accomplished, be returned (or) otherwise disposed of according to the direction of the person delivering them. As a bailee, the banker should protect the valuables in his custody with reasonable care.
- If the customer suffered any loss due to the negligence of the banker in protecting the valuables, banker is liable to pay such loss.
- If any loss is incurred due to the situation beyond the control of the banker, he is not liable for penalty.
- The primary general relationship exists when the account is opened by customer with bank.
- The relationship is that of debtor and creditor. When the bank acts as trustee or agent or bailee for the valuables, he will be establishing the secondary general relationship.

4) Lessor-Lessee

- On hiring out of locker, bank becomes lessor and the hirer a lessee and the relationship is that of landlord and tenant.
- The lessor is not responsible for any loss or damage suitable clause to the effect is also incorporated in the lease deed and hirers are advised, in their own interest, to insure their valuables deposited in locker.

5) Guarantor and Guarantee

- A bank as guarantor gives guarantee to its customer by issuing a 'letter of credit'.
- It is a kind of credit facility to its customer to facilitate international trade.
- A bank guarantee contains an undertaking to pay the amount without any demur on mere demand of the principal amount on the ground for non-performance or breach of contract.

6) Fiduciary Relationship

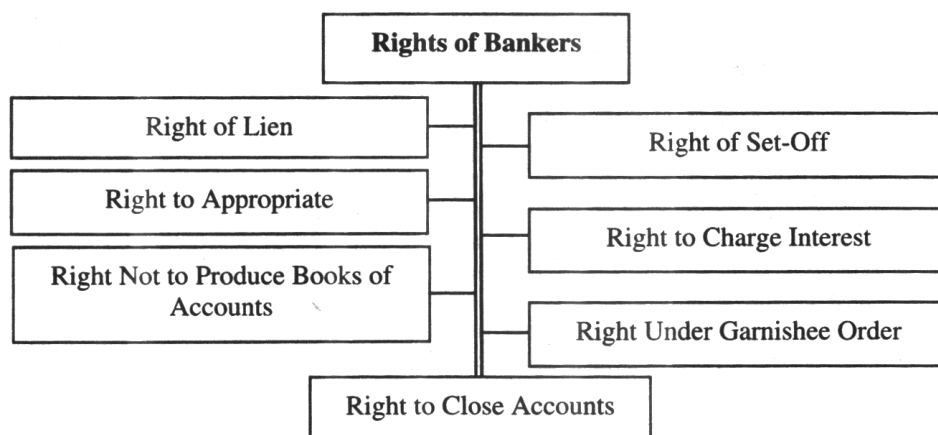
- Every relation of trust and confidence is a fiduciary relation.
- A banker who receives a customer's money is under a duty not to part with it which is inconsistent with the customer's fiduciary character and duty.

2) Special Relationship Between Banker & Customer

The special relationship between banker and customer takes the form of rights which the banker can exercise and the obligations which he owes to his customers.

A) Rights of Bankers

Following are the rights enjoyed by the banker with regard to the customer's account:



These rights are discussed below:

1) Right of Lien

A lien may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property.

- In case lien is exercised by a trader on his customer's goods, he has no right to use the goods, nor any right to sell them.
- All that he can do is to retain the goods until the obligations are cleared. Once the obligations are cleared by the customer, it is an obligation on the part of the trader to return back his goods immediately.
- There are two kinds of lien:

i) **Specific/Particular Lien:** A particular lien confers a right to retain the goods in respect of a particular debt involved in connection with a particular transaction.

- This lien is enjoyed by the persons who have spent their labour on such properties and have not yet recovered their labour charges or service charges from the debtors.

➤ **For example,** a tailor has the right to retain the cloths made by him for his customer until his tailoring charges are paid by customer. So is the case with public carriers and the repair shops.

ii) **General Lien:** A general lien confers a right to retain goods not only in respect of debts incurred in connection with a particular transaction, but also in respect of any general balance arising out of the general dealing between the two parties.

- This right can be exercised only by persons such as bankers, factors, policy brokers, wharfingers, attorneys of High Court, etc.
- The basic object of general lien is to have protection for the bank funds.

- The loans or advances granted to customers can be recovered easily if the general lien is exercised by the bankers.

2) Right of Set-Off

The right of set-off is a statutory right which enables a debtor to take into account a debt owed to him by a creditor, before the latter could recover the debt due to him from the debtor.

- In other words, the mutual claims of debtor and creditor are adjusted together and only the remainder amount is payable by the debtor.
- A banker, like other debtors, possesses this right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one account with the credit balance in the other.

3) Right to Appropriation

Whenever the customer deposits funds into his account in the bank, it is his duty to inform the bank to which account they are to be credited (provided the customer has more than one account at the same bank).

- Once the customer gives specific directions regarding appropriation, the banker has no right to alter them. It is his bounden duty to carry-out the instructions of the customer.
- This right of appropriation is to be exercised by the customer at the time of depositing funds and not later.
- In case the customer is silent or fails to give instructions, the banker has every right to appropriate in his own way.
- In case both have not used their powers, the rule given in Clayton's case would be applicable.

Certain conditions have to be fulfilled to apply the rule in Clayton's case. They are:

- i) This rule cannot be applied to the accounts which were stopped in the middle and revived after certain date.
- ii) The rule is not applicable to broken accounts.
- iii) If two separate accounts are maintained the rule is not applicable.
- iv) Contrary intentions should not be evidenced by the parties concerned.

4) Right to Charge Interest

As a creditor, a banker has the implied right to charge interest on the advances granted to the customer.

- The rate of interest is nowadays levied as per the directions of Reserve Bank of India.
- It is charged on half yearly or quarterly basis and generally compound interest is used.
- The interest is directly debited, i.e., charged to the customer's account and then the interest is calculated on the principal with interest. Interest may also be fixed by the banker and customer by mutual consent.

5) Right not to Produce Books of Accounts

According to the provisions of the Bankers Book Evidence Act, the banker need not produce the original books of accounts as an evidence in the cases in which the banker is not a party.

- He can issue only an attested copy of the required portion of the account which can be utilized as evidence before the court.

- When the court is not satisfied with the certified copy, the court can summon the original books.
- But when a banker is a party to the suit, the court can force the banker to produce the original records in support of his claim.

6) Right under Garnishee Order

The term "Garnishee" is derived from the Latin word "gamire" which means "to warn".

- This order warns the holder of money of judgment debtor, not to make any payment out of it till the court directs.
- It is an order issued by a competent court of law addressed to a banker instructing him to stop (or) withhold payment of money belonging to a particular person who has committed a default in satisfying the claim of his creditors.
- Therefore, whenever a bank receives such an order, the banker has to obey the order fully.

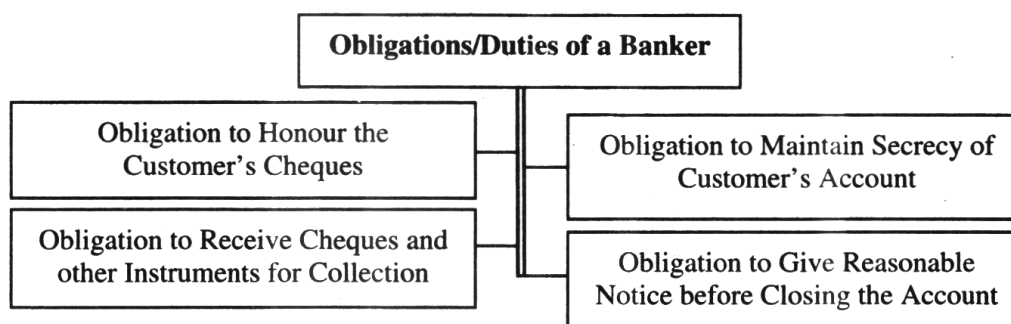
7) Right to Close Accounts

Banker also enjoys the right to close his customer's account and discontinue operations.

- This process terminates the relationship between banker and customer. This is done only in situations where the continuation of relationship seems unprofitable to the banker.
- These are the rights enjoyed by the banker with regard to the customer's account.

B) Obligations of a Banker

Bankers are under the obligations to fulfil certain duties while dealing with customers. Such obligations are as under:



These obligations are as following :

1) Obligation to Honour the Customer's Cheques

Section 31 of the Negotiable Instruments Act, 1881, imposes a statutory obligation upon the banker to honour the cheques of his customer drawn against his current account so long as his balance is sufficient to allow the banker to do so, provided the cheques are presented within a reasonable time after their ostensible date of issue. This are as follows:

“The drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheque, must pay the cheque when duly required so to do and in default of such payment, must compensate the drawer for any loss or damage, caused by such default.”

This provision clearly indicates that the banker should honour the customers demand for payment by cheque on certain conditions which are as following:

- i) **Sufficient Balance:** There must be sufficient funds in the account of the drawer. The cheques sent for collection by the customer are not treated as cash in the hands of the banker until the same are realized. The banker credits the amount of such cheques to the account of the customer on their realization. If the customer draws a cheque on the unrealized amounts, the banker is justified in dishonouring the cheque with the remark “effects not cleared”.
- ii) **Application of the Funds:** The funds must be capable of being properly applied to the payment of customer's cheque. This means, the funds maintained for a specific purpose or trust funds or the funds assigned in the name of some other person cannot be applied for honouring the cheques. Thus, the funds so sought by the customer by cheque should be unencumbered and must be capable of being properly applied.
- iii) **Duly Required to Pay:** The banker is bound to honour the cheques only when he is duly required to pay. This means that the cheque is complete and in order, must be presented before the banker at the proper time. Ordinarily a period of six months is considered sufficient within which a cheque must be presented for payment. On the expiry of this period the cheque is treated as stale and the banker dishonours the cheque. Similarly, a post-dated cheque is also dishonoured by the banker because the order of the drawer becomes effective only on the date given in the cheque.
- iv) **Properly Written:** The instrument used for drawing the amount should be properly written and fulfil and legal obligations.
- v) **Reasonable Time to Collect the Bill:** The banker should have reasonable time to collect the bill or cheque.
- vi) **No Legal Restriction:** There should not be any legal restriction to pass the cheque for payment say in case of Garnishee order, restriction is imposed in the account.
- vii) **Domiciled Bills:** The banker need not honour the cheques presented against domiciled bills.

Thus, the banker should be very careful while honouring a cheque drawn by a customer.

2) **Obligation to Maintain Secrecy of Customer's Account**

In every profession, there are certain things to be maintained absolutely in secret; e.g., a doctor is not expected to disclose the details of his patients to others.

- The profession demands from him that he must maintain those matters in strict confidence.
- Similarly, a bank's profession also demands that he should maintain the particulars of his customer's accounts in secret.
- The banker has an implied obligation to maintain secrecy of the customers account.
- He should not disclose matters relating to the customer's financial position since it may adversely affect the customer's credit and business.
- This obligation continues even after the account of the customer is closed.
- Only in the following circumstances, disclosure is justified:

i) **To Satisfy Statutory Requirements:**

According to the Income Tax Act, the banker is required to give-out information regarding his customers to the Income Tax Department.

- Similarly, whenever the court needs any information regarding the customers, the banker is required to give the information.
- According to the Banking Regulation Act, all banks are required to give in the prescribed forms detailed information regarding the customers to the Reserve Bank of India.

ii) **As a Common Courtesy :** In this case, it is a common practice followed among bankers to exchange information regarding their customers, accounts, etc., as a matter of common courtesy.

- Whenever the banker is called upon to give information regarding his customers, he can do so without any difficulty. As far as possible, he should furnish bare facts while expressing his opinion.
- He should be very careful while expressing his opinion.
- He should not exaggerate nor under-estimate the financial standing of his customers.

iii) **Disclosure at the Will of Customer:**

The banker can disclose the state of affairs of the customer's account when the customer gives his consent to disclose the accounts.

- The auditor of the organization can fully examine the customer's account when an express consent is given by him.
- Similarly, when a customer gives the name of a guarantor, the guarantor can examine the accounts of the customer which the banker should furnish.
- When banker acts as a reference, he can disclose the accounts of the customer.

iv) **To Protect his Own Interest:**

Whenever the banker is required to protect his own interest, if he discloses the details of a customer's account, it must be a reasonable and proper occasion.

- **For example,** if the banker is to recover his own money from a particular customer, he may give the details to his lawyers.

v) **To Protect Public Interest:** The Banking Commission (1972) opined as follows:

When banks are required to give-out information regarding their customers in the interest of the public, the information should relate to financial aspect of the customers.

3) Obligation to Receive Cheques and Other Instruments for Collection

Basically, the business of banking, as it is known today, comprises acceptance of money on deposit account and payment of cheques. It also includes collection of cheques.

- It may rightly be contended that anyone who does not perform these essential services is not a banker.
- Whenever a banker is entrusted with the job of collection of cheques, they must be collected as speedily as possible through the accepted channels. Failure to exercise proper care and employ the recognized route for collection may make the bank liable for any loss which the customer may sustain.

4) Obligation to Give Reasonable Notice before Closing the Account

According to law, a debtor and a creditor may terminate the relationship without notice - by the debtor paying-off the balance or the creditor recalling the debt.

- It is not so simple between a banker and a customer for the obvious reason that the banker is under an obligation to honour his customer's cheques.
- If this obligation could be terminated by the banker without notice, the customer might be faced with an embarrassing situation.
- Reasonable time must be granted to enable him to make alternative arrangements.
- Where any customer becomes a nuisance through overdrawing without arrangement or issuing post-dated cheques, etc., it is advisable to close his account.
- But reasonable time has to be given to enable him to make alternative arrangements if he so desires.
- If a bank abruptly closes the customers account, it might affect his credit, giving cause for an action against the bank for damages.

C) Obligations of Customer's to Banks

Customers are under the obligations to fulfil certain duties while dealing with banks. Such obligations are as under:

- 1) Not to draw cheques without sufficient balance.
- 2) To draw cheques in such a manner so as to avoid any change of alternation.
- 3) To pay reasonable charges for services rendered.
- 4) To make a demand on the banker for repayment of deposit.

Q3. Distinguish between particular lien and general lien.
(or)

Compare contract particulars liena and general lien.

Ans :

S.No	Particular Lien	General Lien
1)	Specific lien is created to secure debts that are associated with a particular property.	General lien is placed on all the property owned by an individual.
2)	Special lien represents property ownerships.	General lien does not represent property ownerships, they are however, creditors claim against a property owner's title.
3)	This lien is enjoyed only by a few persons such as bankers, factors attorneys of high court and policy broker.	It enjoyed by any person who have more labour, time and money on the property retained.

2.3 KYC NORMS

Q4. Define KYC. Explain in detail about KYC norms suggested by RBI.

Ans :

Now-a-days, customers are making more transactions through banking system as banks are providing different kinds of services to their customers.

- This has increased the possibility of misuse and frauds of these facilities.
- Hence, the Reserve Bank of India (RBI) has suggested various banks to practice due diligence in order to understand the nature of their customers and their businesses.
- The RBI has come up with the new idea of 'Know Your Customer' (KYC) and provided detailed guidelines to all the banks and their Board of Directors to formulate an appropriate policy framework in KYC.

KYC Norms

The KYC objective is to avoid the banks from criminal elements for activities of money laundering. The following are the recent KYC norms that RBI has advised banks to include in their KYC policy framework.

1. Customer Acceptance Policy

In customer acceptance policy, banks make sure that all explicit guidelines are followed with regards to below aspects of customer relationship,

- (a) Account should not be opened in fictitious or benami names.
- (b) All essential documents and information must be collected from the customers based on perceived risk and also the need of Money Laundering Prevention Act, 2002.
- (c) Before opening an account, banks should examine the identity of the customer. It should ensure that the customer does not belong to any criminal background like terrorists.
- (d) Customers are allowed to act on behalf of another person or entity only in situations

where the entity is clearly defined as per the established law and practice of the banking.

- (e) The banks must specify the measures of risk perception in terms of customer location, his mode of payments, type of business activity, turnover volume, social and financial status. Based on these parameters, the customers are categorized as low, medium and high risk. The bank may make special focus and monitoring on the category with high risk. Example: Politically exposed persons.

2. Customer Identification Procedure

Under this procedure, banks identify the customer and verify his/her personality using sufficient information, documents, reliable and independent source. The banks must receive the customer's recent photograph, address/location and other identification details.

For legal customers/entities, the banks must verify the following,

- (a) Legal status through necessary documents.
- (b) The other person should be authorised to act on behalf of the legal person, verified. That person's identity must also be
- (c) Ownership and control structure of the customer required to be understood and should decide the natural persons who can control the legal person.

3. Monitoring of Transactions

The banks need to monitor the transactions of the customers on a continuous basis. If banks have an idea of normal/reasonable activity of the customer, then they can successfully control and minimize the risks. Thus, the banks can identify the transactions that are not within the normal activities of the customer.

The bank should focus on the unusual matters and complex/large transaction. Large cash transactions that change with the normal activity of the customer must be considered specifically.

The bank should carefully monitor the high risk accounts. They should maintain the record of account transactions. Any transaction of suspicious nature must be immediately reported to the proper authorities.

4. Risk Management

- (a) Banks must use different anti-money laundering measures while considering the risks associated with a transaction.
- (b) Banks must ensure that the individuals in their audit machinery are well aware of bank's policies and procedures.
- (c) For both existing and new customers, the banks must risk profiles and should implement necessary measures.
- (d) Internal auditors must identify, verify and examine the applications of KYC procedures at the branches.

Reserve Bank of India (RBI) has updated its 'Know Your Customer' (KYC) norms by involving Aadhaar at the centre of the due diligence process. The changes taking place in these norms are however subjected to a final decision taken by the supreme court on Aadhaar related matters.

According to the recently updated KYC norms, banks has to collect the following documents from an individual while carrying out an account based relationship. They include,

- (i) Aadhaar number.
- (ii) Permanent Account Number or Form No. 60.
- (iii) Proof of enrollment for Aadhaar, incase if Aadhaar number has not been assigned.

Other Aspects of KYC

Some of the other aspects of KYC are as follows,

1. Employee Training

Staff members must be trained according to KYC procedures. Training programme should be provided differently to different staff i.e., compliance staff, frontline staff and the staff that deals with new customers.

2. Customer Education

To educate the customer about the objective of KYC programme, the banks must prepare pamphlets or literature.

3. Debit/Credit/Smart or Gift Cards

Banks must make sure that all KYC procedures are applied prior to issuing cards to their customers.

4. Existing Account

The new guidelines are applied to all new customers as well as to the existing customers based on risk and materiality.

2.4 OPENING OF ACCOUNTS**Q5. Explain in detail about opening of an account.**

Ans :

People order to meet their daily expenses, usually save some money and deposit it in bank to keep it safely and earn interest on it. Banks provide facility to open different types of accounts depending on suitability of depositor to withdraw the deposit money. There are different types of deposit accounts which are useful for different purposes, as follow,

(a) Saving Bank Account

Savings bank account are especially for the people who have limited means. In savings account there are some restrictions on withdrawal amount and the number of withdrawals. A minimum balance of ` 500 is needed to open a savings bank account without cheque book. In case of cheque book minimum balance of ` 1000 is required to be present in the account. The procedure for opening of savings bank account is as follows,

(i) Filling up the Application Form

Before opening a savings bank account, the interested person needs to fill up an application form which is available at bank. The application form would include the following information of the applicant.

- Name of the person/persons in whose name account is to be opened.
- Occupation of the applicant.
- Residential address of the applicant
- Specimen signature of the applicant
- Name and signature of the person who is giving surety to applicant and his account number.

- Two passport size photographs of the applicant.

Apart from above information, applicant must give an undertaking stating, that he accepts all the rules and regulations of the bank.

(ii) Introduction of the Applicant

While opening the savings bank account, the applicant must be introduced to the bank by a person who is an account holder of the bank.

(iii) Specimen Signature

Usually at the time of opening an account banker demands a specimen signature of the applicant along with photograph, which is pasted on a specific sheet. This Specimen signature is preserved in order to tally or compare it with signature of depositor for withdrawing the amount. If in case difference is found in both the signatures then the bank would refuse to make the payment.

(iv) Opening of an Account

Soon after completing all the above formalities, bank would open the applicant's account and give an account number, issue a pass book and a cheque book, if the applicant has applied for a cheque book.

(v) Operation of Bank Account

Operating a bank account explains that transactions with bank have started where deposits and withdrawals of money are made by the account holder. A customer must use a pay-in-slip or cheque for depositing in the bank account and withdrawal slip or cheque for withdrawing money from the bank.

(b) Fixed Deposit Account

Fixed deposit account is also referred to as term deposit account. Usually, money deposited in fixed deposit account is for a fixed period of time say 30 days to more than 3 years. An interest amount lying from 6% to 12% is paid on fixed

deposit on the basis of the period for which it is being deposited. Opening a fixed deposit account is similar to that of opening a savings account. The application form must be filled up by the applicant wherein,

- Name, Father's name, residential address etc.
- Amount of deposit and duration of deposit,
- Specimen signature must be provided.

A fixed deposit receipt is issued by bank as an acknowledgment of receipt. It would clearly specify the deposited amount, period, rate of interest and the amount to that would be paid on maturity.

(c) Current Account

Current account is most appropriate for business people and institutions who frequently deal and make withdrawals or deposits. Even overdraft facility is provided on current account and the bank would charge a fee for extended services.

(d) Recurring Deposit Account

Recurring deposit account is best suitable for those people who have regular income but cannot save a large sum of money at one time. In this account, applicant is allowed to save small amount on regular basis for a specific period of time. After the end of period, the depositor would get back the total amount saved along with the interest.

The procedure followed for opening a recurring deposit account is similar to that of the saving bank account. This type of account can be opened by an individual person or combinedly with other person or guardian on behalf of a minor. In this account, a fixed amount is deposited by the customer before 10th day of every month. The interest provided by bank on recurring account is usually more than savings bank account and withdrawal of money before specific period is not allowed. Recurring deposit account can be used as security for taking loan.

2.5 SPECIAL TYPES OF CUSTOMERS

Q6. Explain the various types of special customers.

(or)

Articulate the various special types of customers.

Ans :

Opening of an account binds the banker and customer into a contractual relationship. Every person who is competent to contract can open an account with a bank. The capacity of certain classes of person, to make valid agreement is subject to certain legal restrictions, as is the case with minors, lunatics, drunkards, married women, undischarged insolvents, trustees, executors, administrators etc. Extra care is also needed for the banker while he deals with customers like public authorities, societies, joint stock companies, partnership firms etc.

1. Minors

A minor is a person who has not completed 18 years of age. In case a guardian of his person or property is appointed by a court of law before he completes his 18 years, the period of minority is extended to the completion of 21 years. As per section 11 of the contract act a minor is incompetent to contract but section 26 of the Negotiable Instrument Act allows a minor to draw, endorse, deliver and negotiate a negotiable instrument.

2. Lunatics

A person of unsound mind cannot make a valid contract. So, the bankers should not open an account in the name of a person of unsound mind. But a customer may become lunatic after opening an account with the bank.

3. Illiterate persons

An illiterate person means a person who can't sign his name. While opening of an account of such a person is unavoidable, the banker should obtain

- i) Left thumb impression on the account opening form and specimen signature card in the presence of an authorized bank official
- ii) Details of identification marks should be noted on the account opening form and specimen signature card
- iii) At least two copies of photograph duly attested by any account holder/ authorized bank official.

4. Married women

A married woman can enter into contract and bind her personal (separate) estate. A banker may, therefore, open an account in the name of a married woman

5. Executors and administrators:

Executors and Administrators are allowed to open bank account. Formalities are to be observed while opening the account in the name of executor/administrator:

7. Trustees

A banker must be cautious in opening/ operating a trust account as the trustees are responsible for public money.

8. Joint accounts

Joint account means account of two or more persons who are not partners.

9. Partnership firm

A firm's account should always be opened in the name of the firm and not in the name(s) of the individual partner (s) because a partner does not have (implied) authority to open a bank account on behalf of the firm in his own name.

10. Joint stock companies

A joint stock company is an artificial person and it has a separate legal entity. So, a bank account may be opened on its own name. A joint stock company may either be a Private Limited Company or a Public Limited Company.

11. Societies and other non- trading institutions

The society, be it a club, school, hospital or any institution must be registered as a corporate body. Societies, unless registered are not recognized by the law and have no contracting powers

12. Customer's attorneys

A person may by a written and stamped document appoint a person as his attorney to deal on his behalf with third parties. This power may be general (to act in more than one transaction) or special (to act in a single transaction). The power of attorney can authorize a person to sign cheques (i.e. operate the account) on behalf of the customer.

2.5.1 Minor**Q7. Explain the risk in opening account in the name of a minor.**

Ans :

A minor is a person who has not attained the age of eighteen.

According to Sec. 3 of the Indian Minority Act, 1875, a minor is a person who has not attained the age of 18 and in case a guardian is appointed, till he is 21. But, in England until a person completes his age of 21, he is regarded as a minor or an infant.

The Privileges of a Minor Guaranteed by Law

1. As per Sec. 11 of the Indian Contract Act, a contract entered into by a minor is void. Hence, a minor's contract is not at all enforceable. A contract entered into by a minor is absolutely void as was decided in the case of *Mohri Bibee vs. Dharamdas Ghose*.
2. Even if he borrows money by falsely representing himself as an adult, he cannot be compelled to repay the loan since the contract is a void one.
3. An adult, who gives a bill of exchange for the debt contracted during the period of his infancy, cannot be sued.

4. A minor, who borrows money, cannot be compelled to repay, unless, it is for the necessities of his life as per Sec. 11 of the Indian Contract Act.
 5. A minor has the right to get back the securities pledged for the purpose of securing a loan even without repaying the loan, which is not for the necessities of his life.
 6. A minor can recover even third party's securities pledged, without repaying the debt.
 7. A minor can never be appointed as a trustee.
 8. A minor can enjoy the benefits of a partnership firm. But, he is not liable for the debts of the partnership firm. According to Sec. 30 of the Indian Partnership Act, 1932 a minor must expressly repudiate the contract of partnership within six months of his attaining the age of majority. If he does not do so, he will be regarded as having ratified the agreement. He will be thereafter, regarded as a full fledged partner, and his liability commences from the date of his joining the firm.
 9. A minor can act as an agent of an adult who has given the necessary authority to him. Thus, he can draw, endorse and discount a bill and obtain a loan on behalf of the principal, provided, such powers have been delegated to him in writing.
 10. Sec. 26 of the Negotiable Instruments Act permits a minor to draw and endorse any cheque, bill or promissory note. It will be valid against all parties except a minor.
 11. A minor can be appointed as an executor. But, he can commence his work after his coming of age.
 12. Even a guarantee given by a minor is not valid.
 13. A minor cannot be adjudged as an insolvent either on his own petition or of others.
- In short, minors are regarded as "pet children of law". The above privileges have been given to a minor just to protect his own interest.
- Law protects the minor because he is not mature enough to form a rational judgement on

things, and so, some unscrupulous persons may take advantage of that.

On the contrary, a minor cannot take law into his hands. This is why Lord Kenyon has rightly pointed out that the above privileges should be used as "a shield and not as a sword."

Banker's Duty

As it has been mentioned earlier, a minor, at times, may try to exploit the above privileges and hence, a banker should be very careful while dealing with him. **He must observe the following precautions:**

1. He can allow a minor to open a Savings Bank Account provided the minor is 10 years of age or above and can sign uniformly. In the case of a current account, he must see that the account always shows a credit balance.
2. It is advisable the account in the name of a guardian, who is an adult or a joint account in the name of the minor and the guardian. In that case, the banker can make the guardian liable for all the transactions of the minor. The minor can operate the account as an agent, and he is regarded as a 'ward'.

The guardian may be a Testamentary Guardian, Legal guardian or a Natural guardian. Natural guardian is no other than the father of the minor and after his death the mother. A legal guardian is a person appointed by the Court of Law. A father, may, by a will, appoint a guardian for his minor child and such a guardian is called a testamentary guardian. He can act only after the death of the father/mother.

However, the guardian should not be allowed to operate the account of a minor after the minor has come of age or after the minor's death. On any account, the current account should not show a debit balance.

3. In case a banker is compelled to grant a loan to a minor, he must see that: (a) it is granted either for the necessities of his life against sufficient securities, or (b) against a joint promissory note in which one of the parties

is an adult. (That joint promissory note is enforceable against the adult) or (c) against an indemnity bond given by an adult

4. If the minor dies, the amount of his credit is to be paid to his next of kin on the production of a letter of administration.

2.5.2 Married Women

Q8. Explain the conditions required for a married women during the opening of an account.

Ans :

A banker may open an account in the name of a married woman.

- Like any other customer, she has the power to operate her account herself and the bonafide dealing with the account cannot be questioned.
- But, there was a time when married women were allowed to open accounts only after getting the consent of their husbands. Moreover, all her properties became the properties of her husband on her marriage.
- She was not allowed to hold property in her own name.
- So, the position of a married woman was far from satisfactory in those days.

The Present Position of a Married Woman

1. Now the position of a married woman has been considerably improved. She can open and operate an account even without the consent of her husband.
2. She can now own properties in her own name even after marriage. According to the Hindu Marriage Act, 1956, a Hindu married woman can have separate properties in her own name. Moreover, the Indian Succession Act, 1925, and the Married Women's Property Act, 1874, permit the other women to have properties in their own names.
3. Even though she can own properties, in certain cases, the properties would have been settled in such a way that she can enjoy only the income from those properties and the

ownership would not have been transferred. If a banker was to lend under those circumstances, he could not attach the property for non-payment of the money.

4. But, under certain circumstances, she can make her husband liable for the overdraft enjoyed by her. They are:
 - (a) If she borrows money for the necessities of her life.
 - (b) If she borrows for the necessities of her household.
 - (c) If she acts as the agent of her husband.
5. However, the husband can escape from his liability if he proves that, he has already supplied her with the necessities of life and household and he has never allowed her to act as his legal agent.
6. Further, a married woman enjoys certain other privileges under law. They are:
 - (a) She cannot be imprisoned for non-payment of a judgement debt, and
 - (b) She cannot be made an insolvent, unless, she carries on some trade or business.

Banker's Duty

1. A banker can very well open an account in the name of a married woman. A banker is safe as long as her account shows a credit balance.
2. But, in case she applies for an OD, the banker should see that she owns separate property in her own name.
3. In addition to this, he must see that her husband is also made liable for the repayment of the loan for which he should obtain his consent.
4. In the case of illiterate women, their left hand thumb impression should be obtained on the account opening form.

In view of the above difficulties, a banker is well advised to entertain the application by a married woman to open an account, but not for an OD facility without safeguarding his position.

2.5.3 Partnership Firms

Q9. Explain the procedure of opening in case of partnership firms.

Ans :

A partnership firm is an association of two or more persons called partners who undertake a venture for a mutual benefit.

➤ According to Sec. 4 of the Indian Partnership Act, 1932, a partnership is the "relationship between the persons who have agreed to share the profits of a business carried on by all or any one of them acting for all of them".

➤ A Banker can very well deal with these types of customers, only when, he has a thorough knowledge of the firm and the relevant Act governing the functioning of the firm.

➤ Opening of an Account

Generally speaking, a banker will open an account for a partnership firm only when an application in writing is submitted by any one or more partners.

➤ Under Sec. 19(2) (b) of the Indian, Partnership Act of 1932, authority to open a bank account in the name of an individual partner is positively denied. It follows the well-known decision given in Alliance Bank vs. Kearly, where it was well established that a single partner has no power to open an account in his own name on behalf of a partnership firm.

➤ If he does so, then, it will be a private account, and so, it will not bind the other partners.

➤ Therefore, it is advisable to open the account only in the name of the firm.

➤ The Consent of all Partners

To be on the safe side, a banker should get a written request from all the partners jointly for opening an account.

➤ Partnership Deed

Further, the banker should go through the Partnership Deed and carefully study its objects, capital, borrowing powers etc.

➤ The banker should enquire about the details of the organisation, description of the business, the names and addresses of all the partners and their powers.

- The banker should get a copy of the duly stamped Partnership Deed.
- He should further see whether it is a registered firm or not.
- The interest of the banker would be jeopardised, if he has dealings with an unregistered firm.

➤ **Mandate**

In the absence of a mandate, the partnership account cannot be operated effectively and easily. So, the banker should ask for a mandate duly signed by all the partners. The mandate must contain information regarding:

1. The Name of the Person who is Authorised to Operate the Account

In the interest of the firm and for the safety of the partnership funds, it is advisable that the account is operated by more than one partner. The authority given to operate the account can be revoked by any one of the partners. Likewise, the cheque drawn by a partner can be countermanded by any other partner, so as to secure the safety of the firm's funds.

2. The Extent of Authority Given to such Persons

A banker should know whether the authority given includes the powers to draw, endorse and accept bills, mortgage and sell properties of the firm, overdraw the partnership account and so on. The nature and extent of authority delegated to the authorised person must be put down in writing in clear-cut terms.

3. Personal Account and a Firm's Account

Usually a banker has the personal account of a partner side by side with the partnership account. These two accounts are different in nature. Hence, the banker should note the following :

- (a) He should not mix one account with another and the right of set-off and the lien will not be available against each other.
- (b) A cheque payable to the firm must not be accepted for collection to the private account of the partner without proper enquiry and

without the consent of all other partners. If a banker does so, it will amount to negligence under Sec. 131 of the Negotiable Instruments Act and he will lose the statutory protection.

- (c) But, if a cheque is drawn against the partnership account and is payable to the personal account of a partner, then, the banker should honour the cheque. As he acts in the capacity of a paying banker, the question of wrongful dishonour will arise if, he fails to honour such a cheque.
- (d) With the consent of the partner concerned, the banker can have no objection in transferring the funds from the private account of a partner to the partnership account, but, in any case, the reverse is not permitted.

4. Creation of Mortgage

According to Sec. 19 of the Partnership Act, no partner has an implied power to sell or mortgage the property of his firm. But, Sec. 8 of the Transfer of Property Act lays down that the transferor of an immovable property can transfer the title he has in the property.

5. The Retirement of a Partner

- When a partner retires from business, notice of retirement should be given to the banker.
- If no notice is served, he will continue to be liable even for advances made after his retirement.
- However, a secret partner is not affected by this provision.
- At the time of retirement, if the partnership account shows a debit balance, and if the banker wants to make the retiring partner liable for his share, the banker should immediately close the account and open a new account, to avoid the operation of the rule laid down in Clayton's case.
- Otherwise, any payment made into the account by the newly constituted firm, will automatically discharge the debit balance. It is so because,
- The rule is, the first item on the debit side is cancelled by the first item on the credit side.

- Thus, the retiring partner will escape from his liability.

6. The Death of a Partner

- The death of a partner may or may not dissolve the partnership firm.
- If it does not dissolve the firm, and if the account shows a credit balance, the banker can have no objection to allow the other partners to continue the operation of the account.
- But, he must have obtained a fresh mandate from the remaining partners.
- A cheque drawn in the name of a deceased partner can be honoured after getting the confirmation of the other partners.
- Whether the firm is dissolved or not, if the account shows a credit balance, the surviving partners alone are accountable to the legal representative of the deceased partner for his share in the assets of the firm.
- However, if the account shows a debit balance, the banker must immediately close the account.
- He must open a new account in order to make the deceased partner liable for his share,
- and thus, to avoid the operation of the rule in Clayton's case.

7. The Insolvency of a Partner

- The insolvency of a partner may dissolve a firm.
- Likewise, the insanity of a partner can be taken as a ground for the court's intervention to dissolve it.
- In such cases, the banker may allow the other partners to continue to operate the account, for the purpose of dissolution of the firm.
- The official receiver or the assignee of the insolvent partner cannot interfere in the day to day affairs of the firm.
- But, they can demand an account from the solvent partners and the share of the insolvent in the business. If the account shows a credit

balance, the solvent partners are answerable to the insolvent for his legitimate share.

- Cheque drawn by an insolvent, before the commencement of his bankruptcy but presented afterwards, can be honoured, provided it is confirmed by the other solvent partners.
- At the item of insolvency of a partner, if the partnership account shows a debit balance, the banker must immediately close the account and open a due account to make the insolvent liable for his share.
- The banker should make a claim on the estate of the insolvent with the concerned authority.

2.5.4 Joint Stock Companies

Q10. Explain the conditions required for a joint stock companies during the opening of an account .

Ans :

The operation of a joint account is rather very difficult for a banker, unless he gets clear instruction. While opening a joint account in several names, the banker should get clear instruction regarding the handling of the account. The banker should get signatures of all person concerned with the account on the account opening form. He must know how the account is to be operated, regarding withdrawal of funds, matters relating to bill transaction, advances, securities etc., in the absence of specific directions regarding the operation of the account, the banker will land in trouble. Hence he know, (1) who will operate the account, (2) how the overdraft and advance accounts are to be operated, etc. bankers follow their own policies regarding loan and advances of joint accounts.

If some bankers get comprehensive authority signed by all joint holders covering all possible transactions some other bankers enter into separate agreements regarding advances and take a mandate for cash credits only. Because of these difficulties and complications involved in joint accounts, the banker should make provisions or the contingencies and the following general matters :

- i) **Withdrawals:** the banker should have clear instruction from the account holders as far - as the withdrawals are concerned.
- ii) **Insolvency of a joint account holder:** when a joint account is adjudged as insolvent, the bankers stop the operation of such an account.
- iii) **Nomination:** under section 452A of the banking regulation Act, 1949 the joint holders can nominate a person who will receive the funds on the death of all joint holders.
- iv) **Overdrawing the account:** The Bankers should make clear whether the person authorised to draw the amount is also given the power to 'over draw' the account.
- v) The authority obtained by the banker regarding operation of the account should make very clear whether the mandate also covers the withdrawal of securities deposited for the said joint account by the authorised person.
- vi) **Survivorship:** The authority obtained by the banker should also contain the provision relating to the payment of amount on death of a joint holder.
- vii) **Joint account of husband and wife:** when an account is held by a husband for his jointly with his wife the wife cannot be paid the balance on the death of the husband and it is to be brought into the deceased estate.

2.5.5 Clubs and other Non-Trading Institutions

Q11. State the precautions should a bank take while dealing with Clubs and other Non-Trading Institutions.

Ans :

Clubs, societies, charitable and religious institutions, libraries, schools, colleges etc. are treated as non-trading institutions.

- These non-trading institutions maintain their accounts with the bank.
- So, the bank should take precautions while dealing with clubs and non-trading institutions. They include,

1. Incorporation of Society

A society acquires the legal recognition as a separate entity only when it is incorporated under some Acts such as, The Society Registration Act, 1860, where it provides registration of societies for the promotion of literature, science, fine arts and charitable purposes or the Companies Act 1956 or Cooperative Societies Act. If the applicant society is not registered under any of these laws, they are not liable to enter into a valid contracts. Therefore, the banker should verify the applicant society as an incorporated body in order to sue or to be sued.

2. Managing Committee Determination

The managing committee of the society must consider the following points while opening bank account,

- (i) Providing the name/names of the person or persons, eligible to operate the account.
- (ii) Appointing interested candidates as a banker of the society.
- (iii) Providing any other directions for the operation of the account.

3. Society Rules and By-Laws

Every registered society is regulated by the provisions of the Act under which it is registered. They include the provisions of charter or Memorandum of Association and rules and by-laws etc., in order to conduct its activities.

The society should provide a copy of these provisions to the banker in way to get familiar with the power and functions of the persons who

manages its affairs. Hence, the banker should confirm that these rules are observed by the responsible persons who manages the society.

4. Power of Borrowing the Society

If a registered society aims to borrow, then the banker has to determine the borrowing power of the society from its charter or memorandum. He must also consider the permissible conditions, the powers of the managing committee and the purpose of borrowing. For this purpose of borrowing power of the society, the managing committee is supposed to provide a copy thereof to the banker.

5. Death/Resignation

The banker has to stop the operation of the society accounts on the death or resignation of the authorized person who operates the society accounts. The society has to nominate another person to operate its accounts.

6. Management of Accounts

If the authorized person who operates the society's account holds a personal account in the same branch of the bank, then the banker is under obligation to ensure that the society's funds are properly being credited in society's account but not in personal account of the said person. If such obligation has taken place, then under Sec. 131 of the Negotiable Instruments Act, he will be held guilty of negligence.

Short Question and Answers

1. Define the term banker.

Ans :

Meaning of a Banker

Services provided by today's bankers are far from their traditional activities of merely receiving deposits, honouring cheques, and granting loans.

- The modern day banker issue credit and charge cards, deals in diverse foreign exchange and money market transactions, telegraphic and electronic transfers, bills and trade finance facilities, share financing, custodian, and trust businesses and provides a variety of other banking and investment services.
- Indeed, it is now quite difficult to define the word 'banker' or 'bank' to cover all their diverse and varied activities and functions.
- Essentially, there are two reasons why one needs to know who a banker is.
- First, the nature of the relationship between bank and customer has certain characteristics which may, to some degree, distinguish it from other relationships.
- Secondly, a variety of statutes refer to banks, or to bankers, or to the business of banking.
- A banker is a dealer in capital or more properly a dealer in money. He is an intermediate party between the borrower and the lender. He borrows from one party and lends to another.
- Section 3 of the Negotiable Instruments Act says that the term 'banker' includes any person acting as a banker.

Definitions

- i) **According to Dr. Herbert Hart**, "A banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current account".

- ii) **According to Halsbury**, "A banker is an individual, partnership, or corporation whose sole predominating business is banking, that is the receipt of money on current account or deposit account and the payment of cheques drawn by and the collection of cheques paid in by a customer".

- iii) **According to Justice Homes**, "The real business of a banker is to obtain deposits of money which he may use for his own profit by lending it out again".

2. Meaning of a Customer.

Ans :

The term 'customer' of a bank is not defined by law. In the ordinary language, a person who has an account in a bank is considered its customer.

"A customer is a person who has some sort of account, either deposit or current or some similar relation with a bank and from this it follows that any person could become a customer by opening a deposit or current account or having some similar relation with a bank".

In *Central Bank of India versus Gopinathan Nair*, the Kerala High Court stated, "a customer is a person who has the habit of resorting to the same place or person to do a business".

In order to constitute a person as a customer, he must satisfy the following conditions:

- 1) He must have an account with the bank - i.e., saving bank account, current deposit account, or fixed deposit account.
- 2) The transactions between the banker and the customer should be of banking nature, i.e., a person who approaches the banker for operating Safe Deposit Locker or purchasing travelers cheques is not a customer of the bank since such transactions do not come under the orbit of banking transactions.
- 3) Frequency of transactions is not quite necessary though anticipated.

3. Relation of Debtor and Creditor.

Ans :

The true relationship between a banker and his customer is that of a debtor and a creditor.

According to Sir John Paget, "The relation of banker and customer is primarily that of a debtor and creditor, the respective positions being determined by the existing state of the account. Instead of money being set apart in the safe room, it is replaced by a debt due from the banker. The money deposited with him becomes his property and is absolutely at his disposal". As long as the customer's account shows a credit balance, the banker would be a debtor and in case the customer's account shows a debit balance, the hanker would be creditor.

These are following essentials of debtor-creditor relationship:

1) Creditor must Demand Payment

Although the banker is a debtor and the customer is creditor, it is not at all necessary for the debtor to go to the creditor to pay the amount. This is normally expected in case of commercial transactions where in there are two parties one a debtor and the other a creditor, i.e., ordinary debtor-creditor relationship. But, here in case of banker and customer relationship, though the banker is a debtor, he is not expected to approach the creditor for settlement of dues. Here, the relationship is different and has a special feature, namely, demand is necessary from the customer.

2) Proper Place and Time of Demand

The demand by the creditor must be made at the proper place and in proper time. It means that the customer should present the cheque for payment at that place of the bank where the customer's account is maintained. It is quite clear that at other places, the customers of the state of his account are not known. It is also essential that the customers should demand payment on a working day, i.e., not on a holiday or a day which is closed for public. And in addition, it must be presented during business hours, i.e., it should

not be presented either before or after the business hours.

3) Demand must be made in Proper Form

The demand made by the customer must be in the prescribed form as required by the bank. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the bankers. Otherwise the banker has every right to refuse payment.

4. Right of Lien.

Ans :

A lien may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property.

➤ In case lien is exercised by a trader on his customer's goods, he has no right to use the goods, nor any right to sell them.

➤ All that he can do is to retain the goods until the obligations are cleared. Once the obligations are cleared by the customer, it is an obligation on the part of the trader to return back his goods immediately.

➤ There are two kinds of lien:

i) Specific/Particular Lien: A particular lien confers a right to retain the goods in respect of a particular debt involved in connection with a particular transaction.

➤ This lien is enjoyed by the persons who have spent their labour on such properties and have not yet recovered their labour charges or service charges from the debtors.

➤ **For example,** a tailor has the right to retain the cloths made by him for his customer until his tailoring charges are paid by customer. So is the case with public carriers and the repair shops.

ii) General Lien: A general lien confers a right to retain goods not only in respect of debts incurred in connection with a particular transaction, but also in respect of any general balance arising out of the general dealing between the two parties.

- This right can be exercised only by persons such as bankers, factors, policy brokers, wharfingers, attorneys of High Court, etc.
- The basic object of general lien is to have protection for the bank funds.

5. Distinguish between particular lien and general lien.

Ans :

S.No	Particular Lien	General Lien
1)	Specific lien is created to secure debts that are associated with a particular property.	General lien is placed on all the property owned by an individual.
2)	Special lien represents property ownerships.	General lien does not represent property ownerships, they are however, creditors claim against a property owner's title.
3)	This lien is enjoyed only by a few persons such as bankers, factors attorneys of high court and policy broker.	It enjoyed by any person who have more labour, time and money on the property retained.

6. Define KYC.

Ans :

Now-a-days, customers are making more transactions through banking system as banks are providing different kinds of services to their customers.

- This has increased the possibility of misuse and frauds of these facilities.
- Hence, the Reserve Bank of India (RBI) has suggested various banks to practice due diligence in order to understand the nature of their customers and their businesses.
- The RBI has come up with the new idea of 'Know Your Customer' (KYC) and provided detailed guidelines to all the banks and their Board of Directors to formulate an appropriate policy framework in KYC.

7. The Death of a Partner.

Ans :

The death of a partner may or may not dissolve the partnership firm.

- If it does not dissolve the firm, and if the account shows a credit balance, the banker can have no objection to allow the other partners to continue the operation of the account.
- But, he must have obtained a fresh mandate from the remaining partners.
- A cheque drawn in the name of a deceased partner can be honoured after getting the confirmation of the other partners.
- Whether the firm is dissolved or not, if the account shows a credit balance, the surviving partners alone are accountable to the legal representative of the deceased partner for his share in the assets of the firm.
- However, if the account shows a debit balance, the banker must immediately close the account.
- He must open a new account in order to make the deceased partner liable for his share,
- and thus, to avoid the operation of the rule in Clayton's case.

8. The Insolvency of a Partner.

Ans :

The insolvency of a partner may dissolve a firm.

- Likewise, the insanity of a partner can be taken as a ground for the court's intervention to dissolve it.
- In such cases, the banker may allow the other partners to continue to operate the account, for the purpose of dissolution of the firm.
- The official receiver or the assignee of the insolvent partner cannot interfere in the day to day affairs of the firm.
- But, they can demand an account from the solvent partners and the share of the insolvent in the business. If the account shows a credit balance, the solvent partners are answerable to the insolvent for his legitimate share.
- Cheque drawn by an insolvent, before the commencement of his bankruptcy but presented afterwards, can be honoured, provided it is confirmed by the other solvent partners.
- At the item of insolvency of a partner, if the partnership account shows a debit balance, the banker must immediately close the account and open a due account to make the insolvent liable for his share.
- The banker should make a claim on the estate of the insolvent with the concerned authority.

Choose the Correct Answer

1. The relationship between a banker and a customer is _____. [c]
 - (a) That of a debtor and creditor
 - (b) That of a creditor and a debtor
 - (c) Primarily that of a debtor and a creditor
 - (d) (a) and (b) together
2. The banker has a lien on _____. [a]
 - (a) Bonds given for collection
 - (b) Bonds given for safe custody
 - (c) Bonds left by mistake
 - (d) (a) and (b) together
3. In executing the standing instructions, there exists a relationship of _____. [d]
 - (a) Debtor and creditor
 - (b) Trustee and beneficiary
 - (c) Bailee and bailor
 - (d) Agent and principal
4. To constitute a person as a customer, [c]
 - (a) there must be frequency of transactions
 - (b) there must be a dealing of a banking nature
 - (c) there must be some sort of an account
 - (d) there must be a single transaction of any nature
5. The banker has a statutory obligation to [a]
 - (a) Honour customers' cheques
 - (b) Exercise lien
 - (c) Maintain secrecy of his customers' accounts
 - (d) Honour customers' bills
6. KYC stand for _____. [a]
 - (a) know your customer
 - (b) know youth customer
 - (c) know young customer
 - (d) all
7. General relationship of banker and customer _____. [a]
 - (a) debtor-creditor
 - (b) customer and banker
 - (c) bank and industries
 - (d) all
8. Special relationship of banker and customer [a]
 - (a) assessment of damages
 - (b) debtor, creditor relationship
 - (c) A banker as an agent
 - (d) A banker as a trusty

Fill in the blanks

1. A banker is a _____ debtor.
2. A banker's lien is always a _____ lien.
3. Accepting a bill and making it payable at the bank is called _____ .
4. For wilful dishonour of a cheque, _____ damage is payable by the banker.
5. Special type of customer for bank _____ .
6. Element of KYC norms _____ .
7. To claim a banking debt _____ in writing is necessary.
8. Honouring of a cheque is a _____ obligation, whereas maintenance of secrecy is a _____ obligation.
9. _____ is necessary to exercise a lien.
10. The word 'customer' signifies a relationship in which _____ is of no essence.

ANSWERS

1. Privileged,
2. General,
3. Domiciliation of a B/E,
4. Vindictive,
5. An express demand,
6. Customer acceptancy policy
7. Mimor
8. Statutory, contractual,
9. No agreement,
10. Duration.

UNIT III

Negotiable Instruments:

Descriptions and their Special Features - Duties and Responsibilities of Paying and Collecting Banker - Circumstances under which a Banker can refuse Payment of Cheques - Consequences of Wrongful Dishonors - Precautions to be taken while Advancing Loans Against Securities - Goods - Documents of Title to Goods - Loans against Real Estate - Insurance Policies - Against Collateral Securities - Banking Receipts

3.1 NEGOTIABLE INSTRUMENTS

Q1. What is Negotiable Instruments ? Explain the features of Negotiable Instruments.

Ans :

Meaning

The word negotiable means 'transferable by delivery', and the word instrument means 'a written document by which a right is created in favour of some person'. Thus, the term "negotiable instrument" literally means "a written document transferable by delivery".

Definitions

1. **According to Section 13 (1) of the Negotiable Instruments Act**, "A negotiable instrument means a promissory note, bill of exchange, or cheque payable either to order or to bearer".
2. "A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one of two, or one or some of several payees" [Section 13(2)].
3. **According to Thomas**, "A negotiable instrument is one which is, by a legally recognized custom of trade or bylaw:
 - 1) Transferable by delivery or by endorsement and delivery
 - 2) Without notice to the party liable, in such a way that the holder of it for the time being may sue upon it in his own name and
 - 3) The property in it passes to a bona fide transferee for value free from equities and free from any defect in the title of the person from whom he obtained it.

This means that a person taking an instrument 'Bona fide', and 'For value', known as a holder in due course, gets a good title even though the title of the transferor may be defective.

It declares that to be negotiable they must be made payable in any of the following forms:

1) Payable to Order

A note, bill, or cheque is payable to order which is expressed to be 'payable to a particular person or his order'. For example:

- i) Pay A,
- ii) Pay A or order,
- iii) Pay to the order of A,
- iv) Pay A and B,
- v) Pay A or B.

These are various forms in which an instrument may be made payable to order. But it should not contain any words prohibiting transfer,

Example: 'Pay to A, only' or "Pay to A and none else" is not treated as 'payable to order' and therefore such a document shall not be treated as negotiable instrument because its negotiability has been restricted.

2) Payable to Bearer

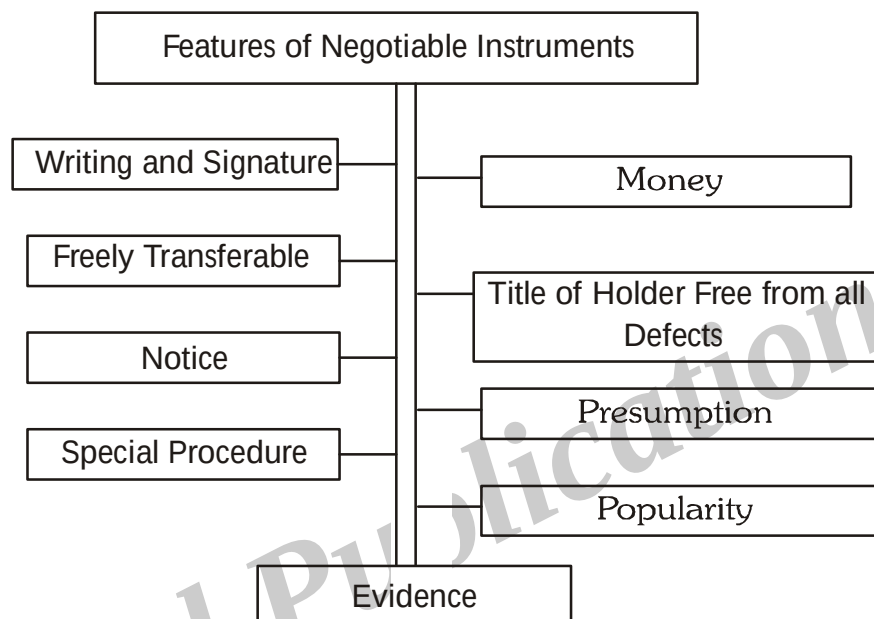
'Payable to bearer' means 'payable to any person whosoever bears it'. A note, bill, or cheque is payable to bearer which is expressed to be so payable or on which the only or last endorsement is an endorsement in blank. Thus, a note, bill, or cheque in the form "Pay to A or bearer", (or) "Pay A, B or bearer", (or) "Pay bearer" is payable to bearer.

Also, where an instrument is originally 'payable to order', it may become 'payable to bearer' if endorsed in blank by the payee.

For example, a cheque is payable to A. A endorses it merely by putting his signature on the back and delivers it to B with the intention of negotiating it (without making it payable to B or B's order). In the hands of B, the cheque is a bearer instrument.

Features of Negotiable Instruments

Features of negotiable instruments are as follows:



1) Writing and Signature

Negotiable instruments must be written and signed by the parties according to the rules relating to Promissory Notes, Bills of Exchange, and Cheques. Demand Drafts are also construed as Negotiable Instruments in the limiting case as they have the same property as negotiable instruments.

2) Money

Negotiable instruments are payable by legal tender money of India. The liabilities of the parties of Negotiable Instruments are fixed and determined in terms of legal tender money.

3) Freely Transferable

The property in a negotiable instrument is freely transferable. They can be transferred from one person to another by a simple process. In the case of order instruments, two things are required for a valid transfer - endorsement (i.e., signature of the holder) and delivery. In case of bearer instruments, it is transferable by mere delivery. Any instrument may be made non-transferable by using suitable words, e.g., "Pay to X only".

4) Title of Holder Free from all Defects

A person taking an instrument 'bona fide' and 'for value' or the transferee of a Negotiable Instrument, when he fulfils certain conditions, known as a holder in due course, gets the instrument free from all defects in the title of the transferor. The holder in due course gets a good title to the instrument even in cases where the title of the transferor is defective. He is not in any way affected by any defect in the title of the transferor or of any prior party.

5) Notice

It is not necessary to give notice of transfer of a Negotiable Instrument to the party liable to pay. The transferee can sue in his own name.

6) Presumptions

A negotiable instrument is always subject to certain presumptions. They will be applicable unless contrary is proved. For example, it is presumed that there is consideration. It is not necessary to write in a promissory note the words "for value received" or similar expressions because the payment of consideration is presumed. The words are usually included to create additional evidence of consideration.

7) Special Procedure

A special procedure is provided for suits on promissory notes and bills of exchange. A decree can be obtained much more quickly than it can be in ordinary suits.

8) Popularity

Negotiable Instruments are popular in commercial transactions because of their easy negotiability and quick remedies.

9) Evidence

A document which fails to qualify as a Negotiable Instrument may nevertheless be used as evidence of the fact of indebtedness.

Q2. Explain the different types of Negotiable Instruments?

Ans :

1) Bearer Instrument

A promissory note, bill of exchange, or cheque is payable to bearer if either of the following two conditions is fulfilled :

- i) It must be expressed to be so payable, or
- ii) The only or last endorsement must be an endorsement in blank.

iii) A promissory note cannot be made payable to the bearer.

iv) A bill of exchange cannot be made payable to bearer on demand. [Section 31 of the Reserve Bank of India Act, 1934].

v) A bearer instrument can be transferred by mere delivery.

Example

"Pay to R (or) bearer"

2. Order Instrument

A promissory note, bill of exchange, or cheque is payable to order if either of the following two conditions is fulfilled :

- i) It must be expressed to be payable to order, or
- ii) It must be expressed to be payable to a particular person and it must not contain words which prohibit transfer or indicate an intention that it shall not be transferable.

Note :

An order instrument can be transferred by an endorsement on it and then its delivery.

Example :

"Pay to R or order"

"Pay to the order of R"

"Pay to R"

3. Inland Instrument [Section 11]

A promissory note, bill of exchange, or cheque is an inland instrument if both the following conditions are fulfilled :

- i) It must be drawn in India,
- ii) It must be payable in India, or it must be drawn upon any person resident in India.

Note :

- i) Protest of inland a bill is optional
- ii) An inland instrument remains inland even if it has been endorsed in a foreign country.

Examples :

- i) "A bill drawn in Delhi on a merchant in Agra and accepted payable in London."
- ii) "A bill drawn in Delhi on a merchant in London and accepted payable in Agra."

4. Foreign Instrument [Section 12]

An instrument which is not an inland instrument is deemed to be a foreign instrument.

Note :

Foreign bills must be protested for dishonour if such protest is required by the law of the place where they are drawn [Section 104].

Examples :

- i) "A bill drawn in Delhi on a merchant in London and accepted payable in London."
- ii) 'A bill drawn in London on a merchant in Agra and accepted payable in Agra.

5. Ambiguous Instruments [Section 17]

An ambiguous bill means an instrument which can be constructed either as a promissory note or a bill of exchange. Its holder may at his option treat it either as promissory note or a bill.

Once he exercise his option, the instrument shall be hence forward treated accordingly.

Examples :

- i) "A bill drawn by an agent acting within his authority upon his principal."
- ii) "A bill drawn upon a fictitious person".

6. Inchoate Stamped Instruments [Section 20]

Inchoate Stamped Instrument is one which is an incomplete instrument.

Where one person signs and delivers to another a paper stamped, in accordance with the law relating to negotiable instrument then in force in India, and either wholly blank or having written thereon an incomplete negotiable instrument, he thereby gives prima facie authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument, for any amount specified therein and not exceeding the amount covered by the stamp. The person

so signing shall be liable upon such instrument, in the capacity in which he signed the same, to any holder in due course for such amount : Provided that no person other than a holder in due course shall recover from the person delivering the instrument anything in excess of the amount intended by him to be paid thereunder.

Notes :

- i) The principal of this rule is one of estoppel.
- ii) The signer is liable if the following conditions are fulfilled :
 - a) The blanks must be filled in and the instrument must be completed.
 - b) The instrument must have been delivered to the transferee.
 - c) The instrument must be stamped one and the stamp affixed must be sufficient to cover the amount filled in the instrument.
- iii) A holder in due course can recover in excess of the amount intended to be paid by the signer provided the amount is covered by the stamp affixed on the instrument.
- iv) The provisions of his Section cannot be applied to a cheque which is not required to be stamped.

Example :

"One not mentioning the amount payable or one without payment".

7. Instruments Payable on Demand [Section 19 and 21]

Instruments payable on demand means the instruments in which no time for payment is mentioned. A cheque is always payable on demand. A promissory note on till of exchange is payable on demand :

- i) When no time for payment is specified, or
- ii) When it is expressed to be payable on demand, or at sight or on presentation.

Notes :

- i) 'At sight' and presentation means on demand.

- ii) An instrument payable on demand may be presented for payment at anytime.

Examples :

- i) "I promise to pay B ` 500".
- ii) "I promise to pay B ` 500 on demand."
- iii) "Pay B ` 500 at sight."
- iv) "Pay B ` 500 on presentation."

8. Time Instrument

Time instruments mean the instruments in which time for payment is mentioned.

A promissory note or bill of exchange is a time instrument when it is expressed to be payable :

- i) After a specified period,
- ii) On a specific day,
- iii) After sight,
- iv) On the happening of event which is certain to happen.
- v) The expression 'after sight' means :
 - a) In a promissory note, after presentation for sight.
 - b) In a bill of exchange, after acceptance or noting for non-acceptance or protest for non-acceptance [Section 21].
- vi) A cheque cannot be a time instrument because the cheque is always payable on demand.

Examples :

- i) "I promise to pay B ` 500 after 3 months."
- ii) "I promise to pay ` 500 on 1st Jan., 1998."
- iii) "I promise to pay B ` 500 after sight."
- iv) "I promise to pay B ` 500 after C's death."

9. Accommodation Bills

An accommodation bill means a bill which is drawn, accepted without consideration.

- i) The accommodated party cannot, after he has paid the amount of the bill, recover the amount from any person who became a party to the bill for his accommodation.
- ii) The person who becomes the holder of such a bill in good faith and for consi-

deration, after maturity, may recover the amount from any prior party [Section 59].

Example :

X who needs funds, draws a bill on Y who accepts the bill and gets the bill discounted with his banker and on due date remits the requisite amount to Y to enable him to meet the bill; such a bill is an accommodation bill.

10. Fictitious Bill

A fictitious bill is a bill in which the name of the drawer or the payee or both is fictitious. When both the drawer and payee of a bill are fictitious persons, the acceptor is liable to a holder in due course if the holder in due course can show that the signature of the supposed drawer and that of the first endorser (payee) are in the same handwriting [Section 42].

Examples :

- i) A bill drawn upon X in favour of P and the drawer is a fictitious person.
- ii) X drawn a bill upon Y in favour of Z who is a fictitious person.

11. Documentary Bill

A documentary bill means a bill to which the documents of title to the goods (i.e., Railways Receipt, Bill of Lading) and other documents are attached.

12. Clean Bill

A clean bill means a bill to which no document relating to the goods (for the transaction of which the bill is being drawn) is attached.

13. Escrow [Section 46]

A negotiable instrument which is delivered conditionally or for a special purpose as a collateral security or for safe custody only and not for the purpose of transferring absolutely the property therein, is called 'Escrow'.

The liability to pay in case of an escrow does not arise if conditions agreed upon are not fulfilled or the purpose for which the instrument was delivered is not satisfied. This however, does not affect rights of a holder in due course.

14. Bills in Sets (or) Set Bills [Sections 132 and 133]

Bills of exchange drawn in parts are called bills in sets. Provisions relating to 'Bills in Set Bills' are :

- i) Each part must be numbered
- ii) Each part must contain a provision that it shall continue to be payable only so long as the other parts remain unpaid.
- iii) Each part must contain reference to the other parts.
- iv) Each part must be signed and delivered by the drawer.
- v) All the parts of the whole set need not be accepted.
- vi) When a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such parts if it were a separate bill.
- vii) As between holders in due course of different parts of the same set, he who first acquired title to his part is entitled to the other parts and the money represented by the bill. [Section 133].

3.2 TYPES OF NEGOTIABLE INSTRUMENTS / DESCRIPTIONS AND THEIR SPECIAL FEATURES
3.2.1 Promissory Note

Q3. Define Promissory Note. Explain the characteristics of Promissory Note.

Ans :

Meaning and Definition of Promissory Note [Section 4]

According to Section 4 of Negotiable Instruments Act, 1881, "A 'promissory note' is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of a certain person, or to the bearer of the instrument".

The person who makes the promissory note and promises to pay is called the maker. The person to whom the payment is to be made is called the payee.

Specimen of Promissory Note

₹ 10,000

Hyderabad

July 10, 2014

Three months after date, I promise to pay Shri Ramesh (Payee) or to his order the sum of Rupees Ten Thousand, for value received.

To,

Stamp

Shri Ramesh,

B-20, Green Park,

Sd/- Raju

New Delhi.

(Maker)

Promissory Note Payable after Date with Interest

Mumbai July 25, 2014

On month after date I promise to pay Ravi Naik or to his order the sum of Rupees one thousand only, with interest @ 12% per annum until payment.

₹ 1,000

Ram Laxman

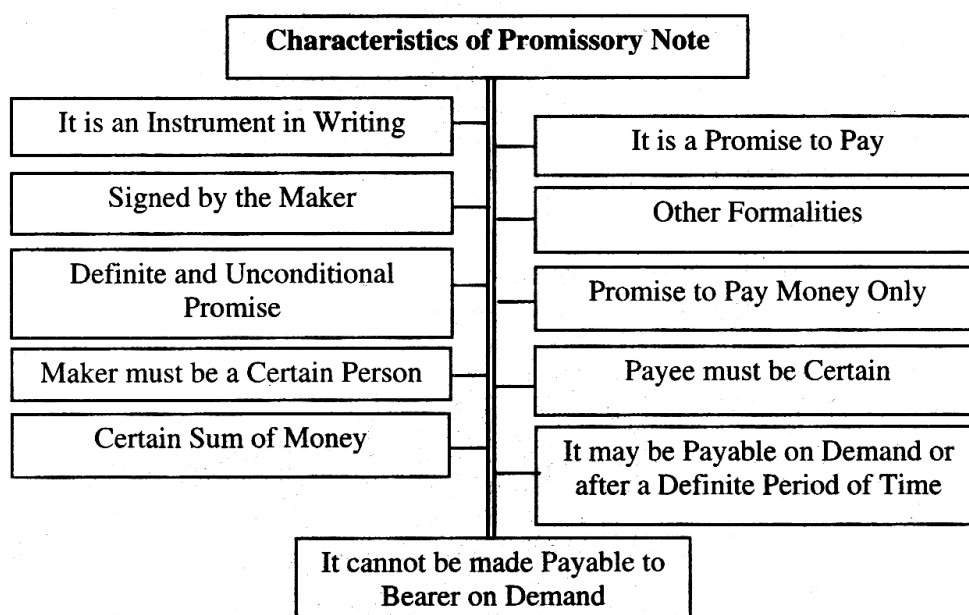
For example, A signs instrument in the following terms:

- 1) "I promise to pay B or order ` 500."
- 2) "I acknowledge myself to be indebted to B in ` 1,000 to be paid on demand, for value received."
- 3) "Mr. B, I owe you (I O U) ` 1,000."
- 4) "I promise to pay B ` 500 and all other sums that shall be due to him."
- 5) "I promise to pay B ` 500, first deducting thereout any money which he may owe me."
- 6) "I promise to pay B ` 500 seven days after my marriage with C."
- 7) "I promise to pay B ` 500 and D's death, provided D leave me enough to pay that sum."
- 8) "I promise to pay B ` 500 and to deliver to him my black horse on 1st January next."

The instruments respectively numbered as (1) and (2) are promissory notes. The instruments numbered (3), (4), (5), (6), (7) and (8) are not promissory notes.

Characteristics of Promissory Note

Characteristics of promissory note are as follows :



1) It is an Instrument in Writing

A mere verbal promise to pay is not a promissory note. The promise should be in writing. The writing may be in ink or pencil, or printing, engraving, or lithographing. It may be in any form, it will be a promissory note so long as it satisfies the other requirements of Section 4.

In other words, an oral promise does not make a promissory note since it is not an instrument.

2) It is a Promise to Pay

There must be an express undertaking or promise to pay. A mere acknowledgement of indebtedness or implied undertaking by the use of the word 'debt' or 'pro-note' is not sufficient and it does not constitute a promissory note.

3) Signed by the Maker

The instrument must be signed by the maker, otherwise it is incomplete and of no effect. Even if it is written by the maker himself and his name appears in the body of the instrument, his signature must be there. Signature means the writing of a person's name in order to authenticate and give effect to the contract contained in the instrument. It is, at the same time, essential that the mind of the signer must accompany the signature.

4) Other Formalities

The other formalities regarding number, place, date, consideration, etc., though usually found given in the promissory notes but are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case, omission of date does not invalidate the instrument if the date of execution can be independently ascertained and proved. The words "value received" is also unnecessary. But a promissory note must be properly stamped as required by the Indian Stamps Act. Each stamp must also be properly cancelled.

5) Definite and Unconditional Promise

The promise must be definite and unconditional. It may be noted that a promise to pay is not conditional if it depends upon an event which is certain to happen but the time of its occurrence may be uncertain.

6) Promise to Pay Money Only

The payment to be made under the instrument must be in the legal tender money of India. If the instrument contains a promise to pay something other than money or something in addition to money, it cannot be a promissory note.

7) Maker must be a Certain Person

The instrument itself must indicate with certainty who is the person or are the persons engaging him or themselves to pay.

In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. Where there are two or more makers, they may bind themselves jointly or jointly and severally.

8) Payee must be Certain

Like the maker, the payee of promissory note must also be certain on the face of the instrument.

A note is valid even if the payee is misnamed or indicated by his official designation only (Section 5) provided he can be ascertained by evidence. It may be made payable to two or more payees jointly or it may be made payable in the alternative to one of two, or one or some of several payees. Thus, alternatives payees are permissible in law. But it must be made payable to order originally.

9) Certain Sum of Money:

The sum payable must be certain or capable of being made certain. Where rate of interest is specified, the sum shall be deemed to be certain. But, expressions like 'market rate of interest' do not make the amount certain since the market rate may vary with the source of borrowing, purpose of borrowing, financial standing of the borrower, and so on. However, a promissory note containing an undertaking to pay the amount 2% above the 'bank rate' (i.e. the rate at which RBI lends to commercial banks) at a given point of time.

10) It may be Payable on Demand or After a Definite Period of Time:

The expression 'on demand' means payable immediately or forthwith.

11) It cannot be Made Payable to Bearer on Demand:

The Reserve Bank of India Act, 1934 prohibits issue of such promissory notes excepted by the Reserve Bank of India itself or the Central Government.

Q4. Explain the parties involved in Promissory Note.

Ans :

Parties to promissory note are as follows :

1) Maker

Maker is the person who promises to pay the amount stated in the note. He is the debtor.

2) Payee

Payee is the person to whom the amount of the note is payable, i.e., the creditor.

3) Holder

He is either the payee or the person to whom the note may have been endorsed.

3.2.2 Bills of Exchange**Q5. Define Bills of Exchange. Explain the parties involved in Bills of Exchange.**

Ans :

A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to , or to the order of, a certain person or to the bearer of the instrument (Sec. 5).

Parties There are three parties to bill of exchange, viz., the drawer, the drawee and the payee.

1. Drawer

The person who gives the order to pay or who makes the bill is called the drawer.

2. Drawee

When the drawee accepts the bill, he is called the acceptor (or) drawee.

3. Payee

The person to whom the payment is to be made is called the payee.

Where the payee named in a bill is a fictitious or non-existing person, the bill is treated as payable to bearer. In some cases the drawer and the payee, or when a principal draws on his agent, the drawer and the drawee may be one and the same person.

The drawer or the payee who is in possession of the bill is called the holder. The holder must present the bill to the drawee for his acceptance.

When the holder indorses the bill, note or cheque, he is called the indorser. The person to whom the bill, note or cheque is indorsed is called the indorsee.

When in the bill or in any indorsement thereon the name of any person is given in addition to the drawee to be referred to in case of need, such person is called a drawee in case of need (Sec. 7). The name of the drawee in case of need may be given in the bill by the drawer at the time when it is drawn or by some subsequent indorser. The resort is to be had to the 'drawee in case of need' only when the bill is dishonoured by non-acceptance or non-payment.

Specimen of a bill of exchange

Rahul of Delhi buys goods on credit from Rakesh of Mumbai for Rs. 500 to be paid 3 months after date. Rakesh buys goods from Ram of Delhi for Rs. 500 on similar terms. Now Rakesh may order Rahul to pay the sum of Rs. 500 to Ram. The order will be a bill of exchange.

Rs. 500

Mumbai, Jan. 10, 2007

Three months after date pay to Ram or order the sum of five hundred rupees, for value received.

To

Rahul

235, Subhash Marg,

Delhi-110006

Stamp

In case of need with

Accepted

Canara Bank, Delhi

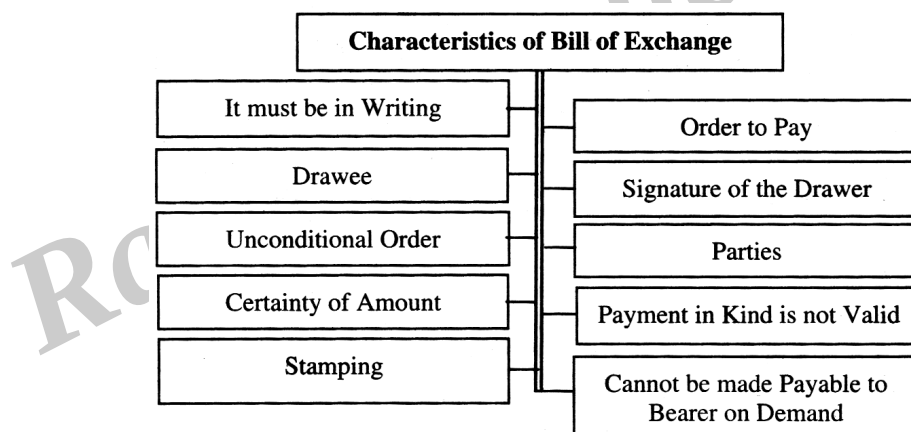
Rahul

Sd/-

Rakesh

Q6. Explain the characteristics of Bills of Exchange.**(or)****Enumerate the features of bills of exchange.***Ans :***Characteristics of Bills of Exchange**

Characteristics of bill of exchange are as follows

**1) It must be in Writing**

The bill of exchange must be in writing.

2) Order to Pay

There must be an order to pay. It is of the essence of the bill that its drawer orders the drawee to pay money to the payee. The term 'order' does not mean command. Any request or direction or other words, which show an intention of the drawer to cause a payment being made by the drawee is sufficient. Politeness may be admissible but excessive politeness may prompt one to disregard it as an order.

3) Drawee

A bill, in order to be perfect, must indicate a drawee who should be called upon to accept or pay it.

4) Signature of the Drawer

The drawee must sign the instrument. The instrument without the proper signature will be inchoate (unclear or unfounded or undeveloped) and hence ineffective. It is permissible to add the signature at any time after the issue of the bill.

5) Unconditional Order

This order must be unconditional, as the bill is payable at all events. It is absolutely necessary for the drawer's order to the drawee to be unconditional. The order must not make the payment of the bill dependent on a contingent event. A conditional bill of exchange is invalid.

6) Parties

The drawer, the drawee (acceptor), and the payee - the parties to a bill are to be specified in the instrument with reasonable certainty.

7) Certainty of Amount

The sum must be certain.

8) Payment in Kind is not Valid

The medium of payment must be money and money only. The distinctive order to pay anything in kind will vitiate the bill.

9) Stamping

A bill of exchange, to be valid, must be duly stamped as per the Indian Stamp Act.

10) Cannot be made Payable to Bearer on Demand

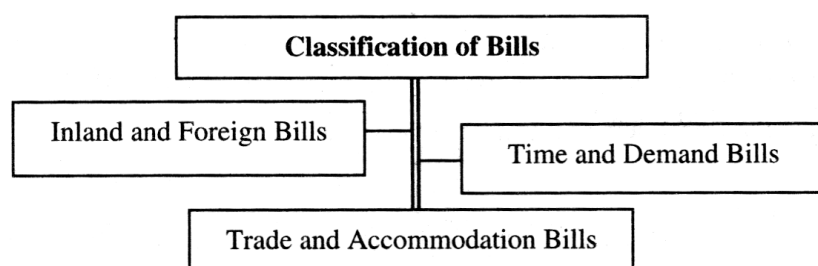
A bill of exchange as originally drawn cannot be made payable to the bearer on demand.

Q7. Explain the classification of Bills.

Ans :

Classification of Bills

Bills can be classified as follows :

**1) Inland and Foreign Bills [Section 11 and 12]:** Inland and foreign bills are as follows:

i) Inland Bill: A bill is termed as an inland bill if:

- a) It is drawn in India on a person residing in India whether payable in or outside India; or
- b) It is drawn in India on a person residing outside India but payable in India.

For example,

- a) A bill is drawn by a merchant in Kolkata on a merchant in Delhi. It is payable in Mumbai. The bill is an inland bill.
- b) A bill is drawn by a merchant in Kolkata on a merchant in Delhi. It is accepted for payment in Japan. The bill is an inland bill.
- c) A bill is drawn by a Delhi merchant on a person in London but is made payable in India. The bill is an inland bill.

ii) Foreign Bill: A bill, which is not inland bill, is a foreign bill. Thus, following are foreign bills:

- a) A bill drawn in India on a person residing outside India and made payable outside India.
- b) A bill drawn outside India and made payable in India.
- c) A bill drawn outside India on any person residing outside India.
- d) A bill drawn outside India on a person residing in India.
- e) A bill drawn outside India and made payable outside India.

2) Time and Demand Bills:

Time and demand bills are as follows:

i) Time Bill

A bill payable after a fixed time is termed as a time bill. A bill payable "after date" is a time bill.

ii) Demand Bill

A bill payable at sight or on demand is termed as a demand bill.

3) Trade and Accommodation Bills:

Trade and accommodation bills are as follows:

i) Trade Bill

A bill drawn and accepted for a genuine trade transaction is termed as "trade bill".

ii) Accommodation Bill:

A bill drawn and accepted not for a genuine trade transaction but only to provide financial help to some party is termed as an "accommodation bill".

For example, A is in need of money for three months. He induces his friend B to accept a bill of exchange drawn on him for ₹ 1,000 for three months. The bill is drawn and accepted. The bill is an "accommodation bill". A may get the bill discounted from his bankers immediately, paying a small sum as discount. Thus, he can use the funds for three months and then just before maturity he may remit the money to B, who will meet the bill on maturity.

In the above example A is the "accommodated party" while B is the "accommodating party".

Q8. What do you understand by a acceptance of a bill under the negotiable instrument Act 1881 and what are the modes of acceptance ?

Ans :

Acceptance of a Bill

The bill of exchange is presented before the drawee for his acceptance. It is necessary for the drawee to sign the bill as this would convey the meaning that the drawee has accepted the bill and has agreed to make the payment on due date then only a bill is said to be accepted by the acceptor/drawee.

Rules for Valid Acceptance

The following are some of the rules which are essential for a valid acceptance,

1. Acceptance Must be Given on the Bill

The drawee should accept the bill by signing his name on the face or backside of the bill conveying that he has accepted the bill. It is optional for the drawee to write the word 'accepted' but it is mandatory for him to sign the bill. Giving signature on the separate paper will not amount to proper acceptance.

2. A Bill must be Accepted Personally or by Agent

In order to make a bill valid, it should be duly signed by the drawee or by his authorized agent. Otherwise, it would be an invalid acceptance.

3. Delivery of the Bill to Holder after Acceptance

In order to make the acceptance valid, the bill must be handed over to the holder after making the acceptance or else the acceptance would be invalid.

The following bills need no acceptance as they are termed to be the accepted bill,

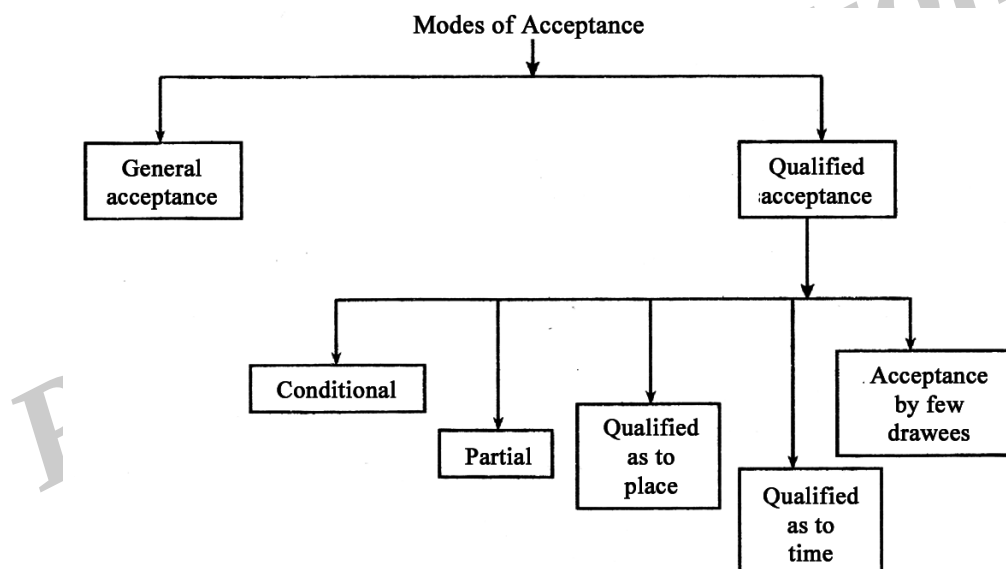
- (i) A bill of exchange payable on demand.
- (ii) A bill payable on a specified date.

The following are some of the bills which needs acceptance,

- (a) A bill including terms and conditions must be presented for acceptance of the drawee before the payment of bill.
- (b) A bill payable after some time that is a bill must be presented at a specified time to fix the date of payment and then it must be represented for acceptance of the drawee.

Modes of Acceptance

An acceptance of bill can be general or qualified.



Figure

1. General Acceptance

When a drawee does not include any terms and conditions on qualification regarding acceptance of the bill, such an acceptance of bill is considered to be general or absolute. When an acceptance is not complete, then the holder of the bill may consider the bill as dishonoured.

2. Qualified Acceptance

Qualified acceptance is the one, where a bill is accepted with certain conditions or qualifications and the effect of the bill gets changed from the way it had been originally drawn. The holder of the bill may not accept the qualified acceptance and may consider the bill as dishonoured by non acceptance. But when the holder of the bill accepts the qualified acceptance, such acceptance binds only him and not the other parties, if the parties do not consent to such qualified acceptance.

An acceptance is qualified in the following cases,

(i) Conditional

Acceptance is qualified with respect to a condition.

Example : Accepted payable when a cargo consigned to Leela is sold.

(ii) Partial

A part payment is made on the sum ordered.

Example : A bill drawn for 1,000 and accepted for 300 only.

(iii) Qualified as to Place

(a) The pay has to be done at a specified place and at the same time other place is treated as a general acceptance.

(b) If the bill is paid or accepted only at a particular place and no where else is treated as a qualified acceptance.

Example : 'Accepted payable at Bank of India only' is a qualified acceptance and accept payable at Bank of India is a general acceptance.

(iv) Qualified as to Time

Where the payment is made at a time, other than the time mentioned in the bill.

Example : 'A bill drawn 3 months after due date and 'Accepted payable 6 months after due date'.

(v) Acceptance by Few Drawees

Acceptance by few drawees but not all where a bill is drawn on other names but it is accepted on/ by them.

Example : A bill drawn on X, Y and Z (not partners), but accepted by X only.

Q9. Distinguish between Bills of exchange and promissory note.

Ans :

Difference between Bills of Exchange and Promissory Note

S.No.	Basic of Difference	Bills of Exchange	Promissory Note
1.	No. of Parties	There are three parties - the drawer, the drawee, and	There are two parties - the maker and the payee.
2.	Promise/Order	A bill contains an unconditional order to pay.	A note contains an unconditional promise to pay.
3.	Nature of Liability	The liability of the drawer of a bill is secondary and	The liability of the maker of a note is primary conditional. and absolute.
4.	Debtor / Creditor	The drawer of a bill is the creditor who directs the drawee (his debtor) to pay.	The maker of a note is the debtor and he himself undertakes to pay.
5.	Identity of Pay or and payee	In a bill, the drawer and the payee may be one	A note cannot be made payable to the maker and the same person. himself.
6.	Acceptance	A bill payable after sight or after a certain period must be accepted by the drawee before it is	A note requires no acceptance as it is signed by the person who is liable to pay. presented for payment.
7.	Payable to Bearer	It can be payable to bearer. It cannot be drawn as	It cannot be payable to bearer. payable to bearer on demand.
8.	Immediate Relation	The drawer of the bill stands in immediate relation with the acceptor and not the payee.	The maker of a note stands in immediate relation with the payee.
9.	Notice of Dishonour	Notice of dishonour must be given to all the persons (including drawer) who are to be made liable to pay.	Such notice is not required to be given to the maker.
10.	Protest for Dishonour	It requires the protesting for dishonour.	It does not require any protesting.

3.2.3 Cheque

Q10. Define Cheque. Explain the characteristics of Cheque.

Ans :

Meaning and Definition of Cheque [Section 6]

Section 6 the Negotiable Instruments Act, 1881 defines a cheque as “a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand”. A cheque is also, therefore, a bill of exchange with two additional qualifications:

- 1) It is always drawn on a specified banker.
- 2) It is always payable on demand.

All cheques are bills of exchange but bills are not cheques. A cheque must have all the essential requisites of a bill of exchange. It must be signed by the drawer. It must contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a specified person or the bearer of the cheque. But it does not require acceptance as it is intended for immediate payment.

Specimen of Cheque

Date.....			
PAY OR BEARER RUPEES			
A/c No.		L.F.	
		INTLS.	
₹			
STATE BANK OF INDIA Kapoorthala Bagh, Lucknow - 226020			
“1147379211”		226002025	

Characteristics of Cheque

Characteristics of cheque are as follows:

1) Written Instrument

A cheque must be an instrument in writing. Regarding the writing materials to be used, law does not lay down any restrictions and therefore cheque may be written either with pen, typewriter or may be printed.

2) Unconditional Order

A cheque must contain an unconditional order. It is, however, not necessary that the word order or its equivalent must be used to make the document a cheque. Generally, the order to bank is expressed by the word “pay”. If the word “please” precedes “pay” the document will not be regarded as invalid merely on this account.

3) Drawn On a Specified Banker Only

A cheque must be drawn on a specified banker. To avoid any mistake, the name and address of the banker should be specified.

4) Certain Sum of Money

The order must be only for the payment of money and that too must be specified. Thus, orders asking the banker to deliver securities or certain other things cannot be regarded as cheques. Similarly, an order asking the banker to pay a specified amount with interest, the rate of interest not specified, is not a cheque as the sum payable is not certain.

5) Payee to be Certain

A cheque to be valid must be payable to a certain person. "Person" should not be understood in a limited sense including only human beings. The term in fact includes "legal persons" also. Thus, instruments drawn in favour of a body corporate, local authorities, clubs, institutions, etc., are valid instruments being payable to legal persons.

6) Payable on Demand

A cheque to be valid must be payable on demand and not otherwise. Use of the words "on demand" or their equivalent is not necessary. When the drawer asks the banker to pay and does not specify the time for its payment, the instrument is payable on demand.

7) Date of Cheques

The drawer of a cheque is expected to date it before it leaves his hands. A cheque without a date is considered incomplete and is returned unpaid by the banks.

The drawer can date a cheque with the date earlier or later than the date on which it is drawn. A cheque bearing an earlier date is antedated and the one bearing the later date is called post-dated.

A post-dated cheque cannot be honoured, except at the personal risk of the bank's manager, till the date mentioned. A post-dated cheque is as much negotiable as a

cheque for which payment is due, i.e., the transferee of a post-dated cheque, like that of the cheque on which payment is due, acquires a better title than its transferor, if he is a holder in due course. A cheque that bears a date earlier than six months is a stale cheque and cannot be claimed for.

Q11. Explain the parties involved in cheque.

Ans :

Parties to Cheque

Parties of cheque are as follows :

1. Drawer

Drawer is the person who draws the cheque, i.e., the depositor of money in the bank.

2. Drawee

Drawee is the drawer's banker on whom the cheque has been drawn.

3. Payee

Payee is the person who is entitled to receive the payment of a cheque.

Q12. What do you mean by crossing of a cheque. Explain different types of crossing.

Ans :

Marking of cheque refers to the writing on the cheque by the drawee banker that the marked cheque would be honoured at the time, when they are made ready for the payment. The custom with bankers related to marking of cheques does not equate to acceptance. The impact of marking of cheque as good by drawee banker is that drawer has no right to counter demand the payee for receiving money.

So far, India has never experienced the practice of marking of cheques. The drawee banker can make cheques good by marking at the instance of,

1. The drawer
2. The holder
3. The collecting banker.

1. Marking at Drawer's Instance

When a cheque is marked at drawer's instance as 'good' it means that the drawee banker possesses/holds sufficient funds which would fulfill the cheque conditions at the time of its payment. If the drawer issues this type of cheque, then later on he won't be able to cancel it.

The banker can exercise his right to dishonour other cheque, if honouring of those cheque makes the account insufficient to meet cheques which are marked good.

2. Marking at Holder's Instance

Marking at holder's instance to the cheque as 'good' means that it is a notice to the holder with respect to the adequate fund in the hands of banker at the time of marking. The banker holds the right of cancelling the cheque, if the drawer withdraws the funds or stops the payment of cheque at the time of its maturity.

3. Marking at Collecting Banker's Instance

Marking at collecting banker's instance is considered as 'constructive payment' as this type of cheque is to be honoured when being presented which is next clearing. Crossing of Cheques

There are two kinds of cheques. They are,

- (i) Open cheque and
- (ii) Crossed cheque.

(i) Open Cheque

A cheque which can be withdrawn at the counter of the bank is called 'open cheque'. The open cheque includes greater levels of risk. If the holder loses it, then the finder can easily withdraw the amount. If the payment of cheque is not cancelled then the finder of cheque can misuse the holder's cheque. Therefore, in order to avoid the misuse of cheque by the finder crossing of cheque is being introduced.

(ii) Crossed Cheque

This type of cheque has two parallel transverse lines with or without the words "and company" can be drawn. The payment of this type of cheque is acquired merely with the help of a banker. Crossing generally ensures safety as the payment made by the drawee banker to the bearer can be easily found out as to which party has received the amount from this crossed cheque. In this type of cheque, if it is paid only through a banker it would give safety measures to the owner and thereby make it compulsory to the holder to present the cheque by way of "quarter of known respectability and credit".

Types of Crossing

The following are the types of crossings of cheques They are,

- (a) General crossing
- (b) Special crossing.
- (c) Restrictive crossing
- (d) Not negotiable crossing

(a) General Crossing

A cheque is said to be crossed if it bears the following,

- (i) The words 'and company' or any acronym if any is written between two parallel transverse lines and includes the words "not negotiable" (or)
- (ii) Two parallel transverse lines which may or may not include the words 'not negotiable' (Sec. 123). When cheque is crossed then the drawee banker is liable to pay when it is presented by banker (Sec. 126).

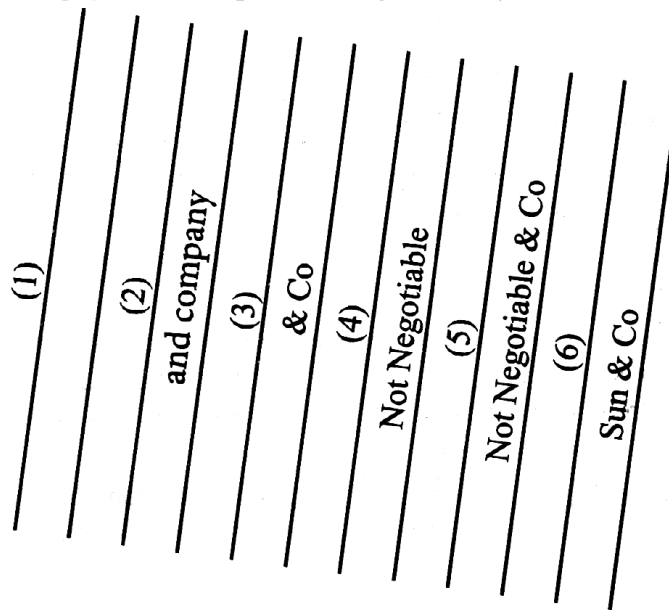


Fig (1): Specimen of General Crossing

(b) Special Crossing

According to (Sec. 124) a cheque is said to have special crossing, when a cheque bears across its face along with the name of a banker the words 'not negotiable'. In case of special crossing transverse lines are not required. The payment of this cheque can be received only through a banker if his name exist on the face of the cheque or between the transverse lines. According to (Sec. 126) the special crossing cheque drawn on banker shall pay to only that banker on whose name it is drawn or to his agent for collection.

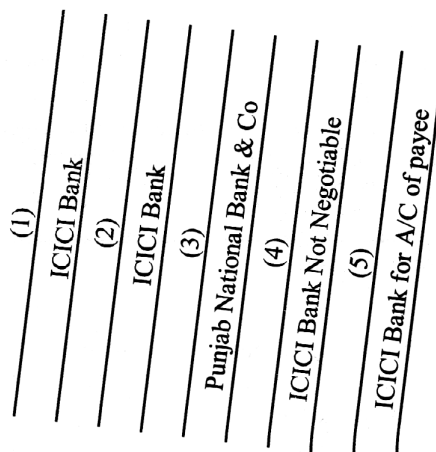


Fig (2): Specimens of Special Crossing

(c) Restrictive Crossing

This type of crossing has been followed by commercial and banking institutions. The words which are added to this type of crossing are "A/C Payee" to the general or special crossing. The words 'A/C payee' gives instructions to the collecting banker that amount received on cheque is to be credited

to the account of the payee. If the collecting banker wrongly credits the amount to different person then he is liable to pay to the owner of the cheque.

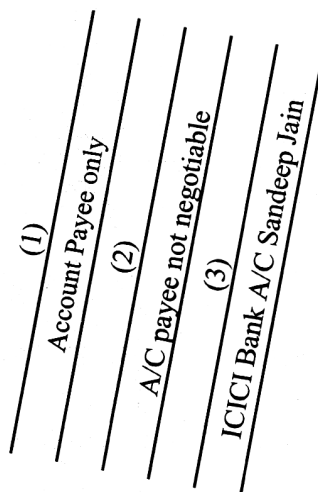


Fig (3): Specimens of Restrictive Crossing

(d) Not Negotiable Crossing (Sec. 130)

The words 'not negotiable' on a crossed cheque implies that the title of the transferee of such a cheque may not be better than that of its transferor. The added words in the cheque 'not negotiable' means the further transferability of cheque is possible but cannot exercise the essential features of negotiability. The holder who possesses the cheque marked as 'not negotiable' is completely responsible for that cheque.

Example

W gave a cheque crossed 'not negotiable' in blank and that blank cheque has been given to his assistant to fill up the amount and the payee's name. The assistant (M) filled the amount more than of what was being told in the cheque and it was sent to P to clear the payment to M. It was held that (M) had no better title and also 'P' had no better title over the cheque issued and 'W is not liable for such situations.

Q13. What are the differences between general crossing and special crossing

Ans :

S.No.	General Crossing	Special Crossing
1.	In general crossing, a cheque bears two parallel transverse lines across its face, either with or without the words not negotiable between them.	1. In special crossing, a cheque bears the banker's name along with the two parallel transverse lines.
2.	Two parallel transverse lines are necessary.	2. Two parallel transverse lines are not necessary
3.	When a cheque is crossed, payment is made only through a banker.	3. When a cheque is crossed, payment is made only to a specified banker whose name is mentioned on the cheque (or) to any of its agents.

Q14. Explain the significance of crossing of a cheque.

Ans :

Significance of crossing of a cheque is as follows:

1) Security of Payment

Crossed cheque ensures the actual payee to receive the money. Since the money is transferred to the payee through bank account so there is no chance of fraud.

2) Safer

Since the payment is done through bank account so crossed cheque is much safer.

3) Reduce Fraud and Cheating

Basically crossed cheque is made to reduce fraud and cheating in transaction.

4) To Reduce Risk

If a crossed cheque is lost even then there will be no chance of losing the money as it takes time to encash. Thus it reduces risk.

5) Heavy Transaction

Crossed cheque is an easier and safer way of transactions. So heavy transactions can be made through crossed cheque.

6) Instrument of Proving

This kind of cheque is used as provable document. At the time of necessity it can be submitted to the court.

7) Conversion

With the permission of the drawer any crossed cheque may be converted into normal cheque. So conversion is another advantage of crossed cheque.

8) Low Cost

No one can encash the crossed cheque except the actual payee. So the holder of the crossed cheque may send anybody to the bank with it to transfer it to the holder's bank account.

9) Creation of Loan Deposit

Since it is compulsory to submit the crossed cheque into the bank, so it creates loan deposits.

10) Easy to Maintenance

Since crossed cheque is very safe so it can easily be transferred from one place to another.

11) Role in Foreign Trade

Generally the transactions in foreign trade are done with crossed cheque so the significance of this cheque in foreign trade is vast.

Q15. Distinguish between cheque and bills of exchange.*Ans :***Difference between Cheque and Bills of Exchange**

S.No.	Basic of Difference	Cheque	Bills of Exchange
1.	Drawer	It is always drawn on a bank.	It is usually drawn on some person or firm.
2.	Payable on Demand	It is always payable on demand	It may be payable on demand or on the expiry of a fixed period.
3.	Acceptance	It does not require an acceptance	It requires an acceptance of the drawee.
4.	Stamp	It does not require a stamp	It must be properly stamped.
5.	Grace Period	It is payable immediately on demand without any days of grace	In the case of a time bill of exchange, three days of grace are allowed from the due date, within which the payment can be made.
6.	Payable to Bearer on Demand	A cheque drawn "payable to bearer" on demand shall be valid	A bill payable on demand can never be drawn payable to bearer.
7.	Crossing	It can be crossed.	It cannot be crossed.
8.	Notice of Dishonour	Notice of dishonour is not required	Notice of dishonour is usually required.
9.	Countermanded	The payment of cheque may be countermanded by the drawer.	The payment of a bill cannot be countermanded.

Q16. Distinguish between cheque and promissory note.*Ans :***Difference between Cheque and Promissory Note**

S.No.	Basic of Difference	Cheque	Promissory Note
1.	Drawer	It is always drawn on a bank.	It is usually drawn on some person or firm.
2.	Payable on Demand	It is always payable on demand	It may be payable on demand or on the expiry of a fixed period.
3.	Stamp	It does not require a stamp	It must be properly stamped.
4.	Payable to Bearer on Demand	A cheque drawn "payable to bearer" on demand shall be valid.	A bill payable on demand can never be drawn payable to bearer.
5.	Crossing	It can be crossed.	It cannot be crossed.
6.	Countermanded	The payment of cheque may be countermanded by the drawer.	The payment of a bill cannot be countermanded.
7.	Acceptance	It does not require acceptance.	It must be accepted by the Drawee.

3.3 DUTIES AND RESPONSIBILITIES OF PAYING AND COLLECTING BANKER

Q17. Who is a paying banker? What are the Duties and Responsibilities of Paying Banker ?

Ans :

Paying/Payee Banker

Under section 31 of Negotiable Instrument Act 1885,

The bank on which a cheque is drawn, the bank whose name is printed on the cheque and which makes the payment by deducting the amount from customer's account for which the cheque is drawn is known as payee banker.

Duties and Responsibilities of Paying Banker

The duties (or) obligations (or) responsibilities of the Payee Banker are as follows,

1. Presentation of Cheque

The Payee banker made responsible to make sure that the cheque is being presented or submitted correctly for the payment. This usually assured by taking into account the following points,

- (i) **Types of Cheque :** Usually, the cheque's are of two types i.e. open and crossed. In case of open cheque, it is to be paid at the bank counter itself, while in case of crossed cheque, the payment is to be made to a follow banker. Date of cheque, post dated cheque or state cheque.
- (ii) **Branch :** The payee banker must assure that which is received by it for encashment or for transfer of funds to another bank, must be drawn on its branch. The Payee banker is not responsible for honouring the cheques which are drawn an another branch of same bank. Therefore, the payee banker would return such type of cheques.
- (iii) **Account :** An individual might have more than one account in the same branch and would have a separate

cheque book for each account. Thus, the payee banker must be clear as to which account is not being used for withdrawing the amount.

(iv) **Banking Hours :** The payee banker must make sure that all the cheques are submitted in bank within banking hours on a business day. If in case any payment which is made after the banking hour would not regarded as payment in due course. Thus, cheques must not be paid on bank holidays in the non-banking hours.

(v) **Mutilation :** The payee banker must not honour those cheques which are being torn into pieces, cancelled or mutilated, cheque should be returned for getting confirmation from the drawer. If in case the cheque is tom by mistake or by accident by the drawer, then he must accept it by writing "Accidentally tom by me" on cheque along with his full signature.

2. Form of Cheque

The payee banker is responsible to check whether the form of the cheque is regular or not. In order to ensure this, the following points need to be considered by the paying banker,

- (i) **Printed Form :** The customer should make use of the printed cheque book provided by the banker for drawing cheque. Otherwise, the banker would reject the cheque for honouring it.
- (ii) **Unconditional Order :** The Payee banker might reject the cheque to borrow, if it involves any condition, i.e. it must be an unconditional order to pay.
- (iii) **Date :** An instrument without date is considered as invalid. In the same way, post dated cheque would be honoured prior to its due date. If cheque is ante-dated and has not become stale, then the bank might honour it.
- (iv) **Amount :** As per the sec. 18 of the Act, if the amount written in figures and

words does not match, then the amount mentioned in words would be considered as the amount to be paid.

- (v) **Material Alterations** : If any material alteration is made in the cheque, then drawer must sign on it. If any changes in the material are observed in, then the payee banker must not honour the instrument.

3. Adequate Balance

If in case the funds in drawer's account are not adequate, then the payee banker holds the right to dishonour the cheque. The bank usually calculates the balance in customer's account, and if incase any overdraft is made, then it would be taken into account.

4. Signature of the Drawer

The payee banker is responsible to make comparison of the signature of the drawer on cheque with that of his specimen signature. If the bank makes payment without comparing, then bank would be liable for the forgery act.

5. Endorsement

The payee banker must check the regularity of the endorsement before honouring the cheque. In case of order cheque, it is quite essential that endorsement is done before delivering it.

6. Minor Duties

The payee banker must also determine if there is any order from customer stating not to pay a cheque.

It must also check for any information available relating to death, insolvency, or insanity of his customer.

Q18. Who is collecting banker ? Discuss the duties and responsibilities of collecting banker.

Ans :

A collecting banker is one who undertakes to collect the amount of a cheque for his customer from the paying banker.

- A banker is under no legal obligation to collect cheques drawn upon other banks for a customer will be satisfied merely with the function of payment of cheque alone.
- Moreover, in-the case of crossed cheque, there is no other alternative to collect the cheques except through some banker.
- In rendering such service, a banker should be careful, because, he is answerable to a number of people with whom he has no contractual relationship and any negligence or carelessness on his part may land him in difficulties.

Duties and Responsibilities of a Collecting Banker

The duties and responsibilities of a collecting banker are discussed below:

1. Due care and diligence in the collection of cheque.
2. Serving notice of dishonor.
3. Agent for collection.
4. Remittance of proceeds to the customer.
5. Collection of bill of exchange.

1. Due care and diligence in the Collection of Cheques

The collecting banker is bound to show due care and diligence in the collection of cheques presented to him.

- In case a cheque is entrusted with the banker for collection, he is expected to show it to the drawee banker within a reasonable time.
- According to Section 84 of the Negotiable Instruments Act, 1881,
- "Whereas a cheque is not presented for payment within a reasonable time of its issue, and the drawer (or) person in whose account it is drawn had the right, at the time when presentment ought to have been made, as between himself and the banker, to have the cheque paid and suffers actual damage, through the delay, he is discharged to the extent of

such damage, that is to say, to the extent to which such drawer or person is a creditor of the banker to a large amount than he would have been if such cheque had been paid.”

- In case a collecting banker does not present the cheque for collection through proper channel within a reasonable time, the customer may suffer loss.
- In case the collecting banker and the paying banker are in the same bank or where the collecting branch is also the drawee branch, in such a case the collecting banker should present the cheque by the next day.
- In case the cheque is drawn on a bank in another place, it should be presented on the day after receipt.

2. Serving Notice of Dishonour

When the cheque is dishonoured, the collecting banker is bound to give notice of the same to his customer within a reasonable time.

- It may be noted here, when a cheque is returned for confirmation of endorsement, notice must be sent to his customer.
- If he fails to give such a notice, the collecting banker will be liable to the customer for any loss that the customer may have suffered on account of such failure.
- Whereas a cheque is returned by the drawee banker for confirmation of endorsement, it is not called dishonour.
- But in such a case, notice must be given to the customer.
- In the absence of such a notice, if the cheque is returned for the second time and the customer suffers a loss, the collecting banker will be liable for the loss.

3. Agent for Collection

In case a cheque is drawn on a place where the banker is not a member of the 'clearing-house', he may employ another banker who is a member of the clearing-house for the purpose of collecting the cheque.

- In such a case the banker becomes a substituted agent. According to Section 194 of the Indian Contract Act, 1872, "Whereas an agent, holding an express or implied authority to name another person to act in the business of the agency has accordingly named another person, such a person is a substituted agent.
- Such an agent shall be taken as the agent of a principal for such part of the work as is entrusted to him."

4. Remittance of Proceeds to the Customer

In case a collecting banker has realised the cheque, he should pay the proceeds to the customer as per his (customer's) direction. Generally, the amount is credited to the account of the customer on the customer's request in writing, the proceeds may be remitted to him by a demand draft.

- In such circumstances, if the customer gives instructions to his banker, the draft may be forwarded.
- By doing so, the relationship between principal and agent comes to an end and the new relationship between debtor and creditor will begin.

5. Collection of Bills of Exchange

There is no legal obligation for a banker to collect the bills of exchange for its customer. But, generally, bank gives such facility to its customers. In collection of bills, a banker should examine the title of the depositor as the statutory protection under Section 131 of the Negotiable Instruments Act, 1881.

- Thus, the collecting banker must examine very carefully the title of his customer towards the bill.

- In case a new customer comes, the banker should extend this facility to him with a trusted reference.
- From the above discussion, there is no doubt to say that the banker is acting as a mere agent for collection and not in the capacity of a banker.
- If the customer allows his banker to use the collecting money for its own purpose at present and to repay an equivalent amount on a fixed date in future the contract between the banker and the customer will come to an end.

3.4 CIRCUMSTANCES UNDER WHICH A BANKER CAN REFUSE PAYMENT OF CHEQUES

Q19. Discuss under what conditions a cheque is dishonoured.

(or)

State the circumstances under which a banker can refuse payment of cheques.

Ans :

When the drawee is unable to make payment on the due date then the cheque becomes 'bounced' (or) 'dishonoured'.

I) Liability of Drawee on Dishonour of a Cheque (Sec. 31)

If the following three conditions are met, then the drawee is liable to compensate drawer on account of any loss or damage resulted because of the non-payment,

- (i) If the drawee possesses adequate funds of the drawer in his hands.
- (ii) If the funds are properly matched to such payment.
- (iii) If the drawee has to make payment by cheque.

II) Liability of Drawer on Dishonour of a Cheque (Sec. 138)

Dishonour of a cheque by drawer leads to imprisonment for 1 year or by imposing fine which should be more than the cheque amount (i.e., double the amount) or both

depending on the fulfillment of the following conditions,

- (i) If the cheque given to the holder consists of legally enforceable debt or fulfillment of any other liability.
- (ii) If the cheque is returned back by the banker on account of inadequate funds in the drawer's a/c.
- (iii) Even though the cheque has been presented to the bank within its validity or within six months of the cheque received to the bank, whichever is earlier but the holder did not get payment.
- (iv) If the payee after receiving unpaid cheque from the bank, gives a written notice to the drawer about the non-payment of cheque and demands for payment of the said amount within fifteen days of the receipt of information from bank.
- (v) If the drawer fails to make payment after receiving notice from the payee, regarding payment of the said amount to payee within fifteen days on receiving the said notice.

a) Cases in Which a Bank Must Refuse to Honour a Customer's Cheque

(i) Stop Payment

On receiving stop payment order from the customer, the bank has the right to reject the customer's cheque.

(ii) Garnishee Order

The bank refuses to honour customer's cheque on receiving Garnishee order (i.e., prohibiting order) from any court.

(iii) Death

On receiving the death notice of the customer.

(iv) Insolvency

On receiving the insolvency notice of the customer.

(v) Insanity

On receiving the insanity notice of the customer.

(vi) Assignment

On receiving the notice of assignment regarding the credit balance of the customer.

(vii) Defect in Title

In case, the bank has a valid reason to prove that the holder of the cheque holds defective title.

(viii) Loss of Cheque

On receiving the loss of cheque notice from the customer.

(ix) Material Alteration

When the bank finds any material alteration change in the cheque without his customer's signature on such alteration / changes.

(x) Different Signature

When the signature does not match with the specimen of the customer given in bank.

(xi) Notice of Closure

On receiving notice of closure of the account.

(xii) Irregular Endorsement

On account of irregular endorsement.

Under the above circumstances the bank may refuse to honour customer's cheque.

b) Cases in Which a Banker May Refuse to Honour a Customer's Cheque

Under the following circumstances, the banker may refuse to honour customer's cheque,

(i) Insufficient Funds

When funds are inadequate in the account than the cheque's amount.

(ii) Funds Not Applicable

On account of non-applicability of funds in the customer's account.

(iii) Presented at Different Branch

If the customer has an account at one branch and the cheque being presented at another branch.

(iv) Presentment After Banking Hours

If cheque is presented during non-banking hours.

(v) State Cheque

If the cheque is presented after its validity or after six months from the date of its issue.

3.5 CONSEQUENCES OF WRONGFUL DISHONORS
Q20. Explain the consequences of wrongful dishonor of cheques.

Ans :

Wrongful dishonours. If the bank wrongly refuses to pay a customer's cheque, it breaches its contract with the customer and is liable for damages. If the customer suffers losses which are directly and foreseeably the result of the dishonour, these losses may be recovered from the bank.

Wrongful dishonor means a refusal or failure to honor within a statutory period, a negotiable instrument or bill of exchange that is properly endorsed and presented for payment. Generally the statutory period for honoring a negotiable instrument or bill of exchange is until midnight of the day of presentment. In cases where the person presenting the check suffers financial loss because of the bank's refusal to honor an otherwise payable check, the bank can be held liable to its customer for damages. However the customer must prove the financial loss.

If the bank wrongly refuses to pay a customer's cheque, it breaches its contract with the customer and is liable for damages. If the customer suffers losses which are directly and foreseeably the result of the dishonour, these losses may be recovered from the bank. The most common damage is to the customer's credit. If the customer is a trader, then this damage is considered to be so inevitable that it is not even necessary to prove any actual damage. Customers who are not traders must prove damage to their credit.

There may be damages for *defamation* as well as for breach of contract. This occurs because it is common for the bank to note on the cheque the reasons for the dishonour. Many non-trading

customers, for example, those engaged in other forms of business, clergy or others whose reputation is an essential part of their calling, may obtain substantial damages as a result of defamatory notations on the cheque. 'Present again', 'not sufficient funds', 'refer to drawer' and other phrases suggesting the customer has written a cheque without having adequate funds in the account, are nearly always defamatory. Of course, these damages are only available if the dishonour was wrongful.

Dishonour of Cheques – Consequences Under 138 of the Negotiable Instruments Act, 1881

Payment by cheque is a part and parcel of our banking system. A cheque is an order to a bank to pay a specific amount of money from a person's account to another. Cheques are negotiable instruments under the Negotiable Instruments Act, 1938 and their dishonour is dealt under section 138 to 147 of the Act that provides for remedies and various forms of punishments for defaulters.

While cheques are a safe and easy way to make payments without the hassles of carrying around large sums of money, they carry with them the risk of dishonour. As per statistics, there are an estimated 18 lakh cheque bounce cases across the country, of which about 38,000 are pending in High Courts. The bulk of economic crimes handled by the police also pertain to cheque bouncing. It was in this backdrop that Section 138 of the Negotiable Instruments Act, 1881 came into being.

Section 138 makes dishonour of cheque for insufficiency of funds in the Account a criminal offence punishable by imprisonment of up to one year. It further states that a drawer of a dishonoured cheque shall be deemed to have committed an offence and he shall be punished with imprisonment of up to one year or with fine which may extend to twice the amount of the cheque or both. Thus if a cheque bounces, a *prima facie* case is made out against the issuer and he is liable to be prosecuted for the same.

The following are the essential requirements of prosecuting an offender under Section 138 for Cheque Bouncing :

- ▶ The dishonour of cheque should have occurred due to insufficiency of funds in the issuer's account;
- ▶ The cheque should have been presented by the payee within six months (now three) of being drawn;
- ▶ The payee should give a demand notice within 30 days of bouncing of the cheque;

Presumption in Favour of Holder

It is important to note that in cases under Section 138, there is a presumption in favour of the holder of the cheque. The mere issuance of cheque is concrete proof of the fact that payment was due to the holder. If the cheque bounces, then the burden of proving innocence falls on the issuer. Thus, Section 139 clearly presumes that the holder of a cheque had a payment or debt due to him and the cheque was issued to discharge that liability. The burden of proving the opposite (that no debt or liability existed) lies on the Issuer.

Defense Which May Not be Allowed in Any Prosecution Under Section 138

In order to keep a stringent check on cheque bouncing cases, Section 140 of the Negotiable Instruments Act provides that a person drawing a cheque cannot take up the defence that when he drew the cheque he had no idea that his credit balance in the account was insufficient. Thus, the issuer of the cheque cannot claim ignorance of his bank balance and give the excuse that the cheque was issued by mistake. Likewise, the issuer of a Blank Cheque cannot claim immunity from prosecution on the ground that he only signed a blank cheque and the amount was filled in by someone else. Thus if a cheque bounces, the mere fact that the person put his signature on it is sufficient to launch prosecution against him under Section 138 of the Negotiable Instruments Act, 1881.

Thus, Section 138 of the Negotiable Instruments Act, 1881 is a powerful provision to ensure discipline in the business world. The stringent penalties under Section 138 are indeed justified as cheque bouncing is tantamount to cheating. It undermines confidence in the banking system and undermines business relations. Therefore every

person accepting cheque payment should be vigilant of his rights and any case of dishonour should be immediately and vigorously pursued under 138 to its logical conclusion.

3.6 LOANS AND ADVANCES

Q21. Define loans and advances. Classify the different types of loans and advances.

Ans :

Loans and Advances

According to Section 5(n) of the Banking Act, 1949, a secured loan or advance is "loan or an advance made on the security of assets the market value of which is not at any time less than the amount of such loan or advance".

Loans and advances constitute by far the most important revenue of investment of banker's resources and are the principal source of profit. Other sources of income such as bank commission and charges are small.

Types of Loans and Advances

According to the needs and requirements of customers, commercial banks provide different types of loans and advances as follows,

1. Demand Loan

These loans are sanctioned against goods and documents of title of goods, bank's own fixed deposits, gold ornaments. These loans are for short period.

2. Term Loan

- (a) 1 to 5 years medium term, 5 to 10 years long term.
- (b) A bank loan with a floating interest rate and which is repaid over a specific period of time i.e., from 1-10 years is known as term loan.

3. Cash Credit

Cash credit is one of the facilities which is provided by the banker wherein, the borrower is allowed to withdraw the amount up to a particular limit. The customer's account is credited with the amount and he can make the withdrawals as per his needs.

The bank usually charges interest on amount which is withdrawn and not on the complete amount which is being credited to the borrower's account. In cash credit, the banker clearly mentions a particular limit of loan for the customer, which is termed as cash credit limit. If suppose the customer maintains the account properly, then cash credit limit would be renewed by the bank at the year ending.

4. Overdraft

The term 'Overdraft' refers to the act of overdrawing from bank account. In overdraft, the account holder is enabled to withdraw amount which is usually more than the credit balance in his/her account. This facility is basically given for a shorter period of time to those customers who carry out their transactions via cheques. Overdraft facility is usually given on security on assets or on personal security.

5. Discounting of Bills of Exchange

Bill discounting is another type of facility which is usually provided by discounting the general trade bills i.e., doing the payment prior to the due date of bills and after excluding a particular discount rate. On due date, bank submits the bill to the borrower's customer and collects the complete amount. In case, if the bill is dishonoured then bank collects the amount along with interest from the borrower or his customers. Bill discounting is an advance which is given for security of bill. Bank verifies the creditworthiness of drawer and genuineness of the bill before discounting it.

Q22. What are the general principles of sound lending?

Ans :

General Principles of Sound Lending

Since all loans entail a credit risk, the banks have to follow the following principles:

1) Safety

'Safety First' should be the guiding principle to be followed in granting loans and

advances. Since banks deal with the money of their customers, they have to ensure the safety of the funds lent. Safety means that the borrowers should be in a position to repay the loans borrowed with interest, as and when they are due. The repayment of borrowers in-turn depends upon

- (i) their capacity to repay,
 - (ii) their willingness to-repay, and
 - (iii) the collateral security offered.
- The capacity of a borrower depends upon the success of his venture. The willingness depends upon his honesty and integrity:
 - Hence, before lending money, the banker should ascertain whether the borrower is a person of good character and integrity and whether the security offered is adequate and easily realizable.

2) Liquidity

Liquidity is nothing but the ability of a banker to convert a asset into cash readily without much loss in its value.

- In other words, a bank has to maintain a liquid position, so that, he can meet the demands of his customers at any time. Money granted for long periods are less liquid because they cannot be received back in times of need.
- Liquidity also depends upon the type of the asset a banker selects, while granting loans and advances. It is appy said "a prudent banker is one who knows the distinction between a bill and a mortgage". It is so because; a mortgage is a long term loan.
- Creation of a mortgage involves much formalities and expenses. Moreover, a mortgage cannot be converted into cash readily. A mortgage is always created against immovable assets, and hence, they are very difficult to realize.
- On the other hand, a bill is purely it can be converted into cash immediately by rediscounting it with the Central Bank.

- Hence, the principle of liquidity demands that a banker should confine his lending to short term, against assets which can be' converted into cash immediately.

3) Profitability

Commercial banks also exist for earning profit. A banker cannot run the banking business" without profit. Profit is essential to meet the day-to-day expenses, to pay interest on deposits, to meet the salaries of staff etc.

- Profitability demands that a banker should employ all funds to earn maximum profit. But, liquidity demands that the banker should maintain a large cash reserve to meet the demands of customers.
- Thus, these two principles are opposing to each other. In fact, an experienced banker knows that these tow opposing factors must meet with each other at a point called safety. Hence, safety and liquidity should" not be sacrificed for profitability.

4) Security

No banker sees the horoscope of a customer and lends. He calculates his lending risk and lend. To minimize the chances of risk, security should be insisted upon. The security must be adequate, easily realizable and free from encumbrances. But, undue importance should not be given to securities. They are like cushion to fall back upon in times of need.

5) Purpose of the Loan

Another important cannon of lending is that the purpose of the loan must be enquired into by the banker. Repayment of loans mainly depends upon the purpose for which loans are needed. For instance; loans for productive purposes would enhance the earning capacity of the borrower, and thus, it would pave way for easy repayment. Loans for unproductive purposes, hoarding, black marketing, social ceremonies etc., are risky, since, there is no guarantee of repayment. So, they are not entertained. After

nationalization, the purpose of the loan is given more weightage than the security offered for the loan.

6) Diversification of Risks

Since every loan entails some risk element, it is advisable to spread the credit risk. This can be done by granting moderate loans to a large number of customers, spreading over a wide area.

- In other words, a banker would not concentrate all his loanable funds in one industry or one particular area or a group of few customers only.
- If he does so, his very survival is questionable, particularly, when a particular industry fails, or when there is an adverse change in one place, etc. This is in accordance with the maxim "Do not lay all eggs in the same basket".

7) Assured Repayment

A banker should come forward to lend only when the repayment is assured. When there is default in repayment, a banker's ability to create further credit is affected.

- Hence, while advancing money, he should see the source of repayment.
- **For eg.,** loans against a FDR which is going to mature shortly, a Life Insurance Policy which is going to mature soon, a debenture which is to be redeemed shortly etc. are considered as sound loans.
- Thus, a sound and safe credit is one, where timely repayment is assured.

8) Social Objectives

While making advances, the banker should give the highest priority to the national interest. Today banks have a strong social objective and social conscience. It is the responsibility of each and every bank to ensure that the bank credit flows smoothly to the neglected sectors of the economy and to the under privileged sectors of the society. Towards this end in view, banks have given up their "security-oriented lending" and have

taken up "need-based loans" or "productivity of the loan". The viability of a project is given more weight than the security behind a loan.

9) The Law of Limitation Act

A lending banker should also bear in mind the Law of Limitation Act. According to this Act, a debt will become a bad one after the expiry of 3 years from the date of the loan it is applicable to loans and advances granted by banks. Hence, each and every banker should be very careful in renewing the loan, year after year. Otherwise, these loans would become bad subsequently.

3.6.1 Precautions to be taken while Advancing Loans

3.6.1.1 Precautions to be taken while Advancing Loans against securities

Q23. Write a short note on advances against stock exchange securities. State the precautions to be taken by a banker while making advances against stock exchange securities.

Ans :

Advances Against Stock Exchange Securities

It is an organized market where securities are sold and purchased. The following securities are traded on the floor of stock exchange,

- (i) Companies shares and debentures
- (ii) Central and state government bonds
- (iii) Securities such as port trusts, improvement trusts, electricity boards etc, issued by semi-government authorities.

Precautions while Advancing Against Stock Exchange Securities

The following precautions must be taken by the banker while making advances against stock exchange securities,

1. Securities Selection

Before selecting securities a banker must examine the approved list of securities which has to be dealt on the stock exchange. The banker must study the audited profit and loss and balance sheets, the progress and working of all companies and constitution of

companies board of directors. Based on the above study, the banker must prepare a list of securities against stock exchange on which advances will be made.

2. Valuation of Securities

After the selection of securities, the banker will determine the value of shares and securities. Securities are taken at their market value and shares prices are quoted cum dividend. Dividends are deducted from the present market value.

3. Equal Margins

The banker must keep equal margins against securities in order to avoid any losses due to heavy fall in the prices of securities.

4. Preference Shares and Debentures

The banks must go for preference shares and debentures, government and semi-government securities because their price fluctuations are very less.

5. Partly-Paid Securities

A banker must not advance for partly-paid securities. In case of highly credit worthy customer, the bank can provide loan against partly-paid securities. In this regard the bank must take an undertaking from such customer to pay the call, if made by the company.

6. Transfer of Securities

In case of bearer and negotiable securities the banker will get the title by mere delivery. In case of registered securities, a transfer deed is prepared by the bank and must be signed by the customer. At the time of repayment of loan the shares are transferred to the customer. If the customer is unable to repay the loan, the banker will fill the dummy transfer deed duly signed by the customer, register in its own name and later sell the securities to make the loan amount.

7. Notice to the Company

A banker will issue a notice to the company regarding its interest in the shares of the company. This will reduce the risk of duplicate certificate by the company.

3.6.1.2 Precautions to be taken while Advancing Loans Against Goods

Q24. Define advance against goods. State the precautions to be taken by a bank while granting advances against goods.

Ans :

Advances Against Goods

According to Lord Chorby "advances against security of goods are a usual and proper form of banking business". Banks provide funds against goods, the goods can be agricultural products or manufactured goods. In India, most of the banks are providing their funds against security of goods through pledge or hypothecation.

Precautions in Advancing Against Goods

The following precautions must be taken by a bank while granting advances against goods,

1. Borrower Character

The bank must consider the honesty, trustworthiness and integrity of the borrower at the time of granting advances against goods.

2. Experience of Borrower

The bank must check whether the borrower is an experience person in a particular business or not because dealing with an inexperienced person will be a risk for the banks.

3. Title to the Goods

The bank must find out the borrower's genuine title to the goods through cash receipts or invoices.

4. Nature of Goods

The bank must also consider the nature of the goods. It should prefer only those goods which can be stored for longer period of time and easily realizable goods.

5. Purpose of Loan

The bank should also find out the reason why customer is taking a loan against goods. The loan is provided only for the productive purposes and for the resale of goods.

6. Valuation of Goods

Goods are valued with proper care and even an expert will be appointed to value the goods. He must compare the prevailing prizes and prices quoted in the bill at the time of valuation of goods.

7. Insurance

Goods must be insured with the full market value and against all possible risks. The receipt of such policy/premium is with the bank only.

8. Periodical Inspection

Goods kept in the godown should be periodically inspected by the bank. The quality and quantity of goods should not get affected while storing goods in the godown.

9. Short-term Loan

Only short-term loan is provided against goods because of decline value of goods due to their quality deterioration.

10. Bank's Name Board

The pledged goods stored in the godowns must be locked with the bank's padlock. The bank's name board, reading "Goods pledged to bank" must be permanently attached in an appropriate place outside the godown.

11. Others

Some other precautions which must be taken by the bank while advancing against goods are directives of Reserve Bank, possession of goods, proper storage, strict supervision over the release of goods, care in the rented godown etc.

3.6.1.3 Precautions to be taken while Advancing Loans Against Documents of Title to Goods

Q25. What are the documents of Title to Goods ?

Ans :

As per the Section 2(4) of the Sale of Goods Act, 1930, a document of title to goods is 'a document used in the ordinary course of business as a proof of possession or control of goods

authorizing or purporting to authorize either, by endorsement or delivery, the possessor of the documents, to transfer or receive the goods thereby represented.' Thus, the essential requisites of a document of title to goods are:

- (i) The mere possession of the documents creates a right either by virtue of law or trade usage, to possess the goods represented by the documents.
- (ii) Goods represented by the documents can be transferred by endorsement and/or delivery of the documents.
- (iii) The transferee of the documents can take delivery of the goods in his own right.
- (iv) Although they appear to be negotiable instruments, documents of title to goods are not negotiable instruments. The title of bona fide transferee for value can be affected by defects in the title of transferor. They may be called quasi-negotiable instruments.

Examples of documents of title to goods are bills of lading, dock warrant, warehouse-keeper's certificate, railway receipts, delivery orders, etc. Documents of title to goods must be distinguished from other documents like the warehouse-keeper's non-transferable receipts, which are mere acknowledgement of the goods. Documents of title to goods are preferred by bankers because under Section 52(2)(e) of the Presidency Towns Insolvency Act, 1909, and Section 28(3) of the Provincial Insolvency Act, 1920, possession of goods represented by such instruments duly endorsed in his favour are taken out of the order and disposition of the insolvent. The significance of this is that in case the borrower becomes insolvent, the Official Receiver or Official Assignee as the case may be, cannot include such goods in the assets of the insolvent.

Q26. State the precautions to be taken by a bank while granting advances against documents of title goods.

Ans :

1. Integrity of the customer

The foremost consideration while advancing against documents is to ascertain, that the

customer is honest, reliable and trustworthy. The documents are not negotiable instruments and do not convey better title and hence the banker has to rely solely on the integrity of the borrower. The experience of the customer in his trade should also be taken into account.

2. **Certificate of packing:** To ensure that the goods packed conform to the description contained in the document, the banker should obtain a certificate from a reliable firm of packers.
3. **No onerous conditions:** Care should be taken to see that the documents contain no onerous clauses which make the documents unfit to be a security. For example, a 'foul bill of lading' might contain remarks such as 'packages broken.' Such documents should never be accepted.
4. **Endorsement in blank:** The banker should get the documents endorsed in blank. If it is endorsed in blank, the freight, if any, payable on the goods will be paid by the customer.
5. **Insurance against risk:** The goods must be insured against fire and other risks for its full value. The banker should also insist on the submission of the insurance policy with details of the risks covered by it.
6. **Special care in releasing the goods:** It is advisable on the part of the banker, not to part with the security before repayment of advance. In exceptional cases, when he delivers them, he should insist upon the execution of a Trust Deed. The effect of such a Deed or Receipt is that the customer agrees to hold the goods or sale proceeds of the goods as trustee on behalf of the banker. The trust is liquidated when the borrower hands over the documents. In **Chartered Bank of India Vs. Imperial Bank of India**, it was held that if the borrower fails to return the documents or goods or sale proceeds to the banker, he will be liable for criminal breach of trust.

In dealing with the documents, a banker must make a clear distinction between:

- (i) Those documents which give the possessor a right of ownership.
- (ii) Those which are simply acknowledgement of receipt of goods,

The distinction would help the banker in the event of insolvency of the borrower. In the former case, the possession of bill of lading or dock warrant is sufficient to claim against the Official Receiver, whereas in the latter case, the possession of Warehouse Keeper's Certificate would not provide him with a right to claim against the Official Receiver,

3.6.1.4 Precautions to be taken while Advancing Loans Against Real Estate

Q27. Write a short note on advances against real estate. What are the causes of refusing real estate as security by a bank? State the precautions to be taken by a bank while lending money against the security of real estate.

Ans :

Advances Against Real Estate

Commercial banks do not prefer to grant loan against real estates because it involves heavy risk. In case when the customer does not have any other security to offer, then only the banks accept real estate as security. As the name indicates "real estate" are immovable properties including tangible assets such as land, building etc.

Causes of Refusing Real Estate as Security

The following are the causes of refusing or drawbacks of real estate as security,

1. Customer's Title

The major drawback while advancing against real estate is customer's title. It becomes difficult for the banker to know the customer's interest in the property. In case of agricultural land as security, the banker has to spend more money and time to verify the customer's title and on the other hand the property will be a disputed one.

2. Large Expenses

A customer will take long term loan against real estate as he has to spend large amount in mortgaging the property.

3. Valuation

Valuation of property is another major demerit for banks. The banks has to appoint qualified valuers to value the construction and location of immovable property which is another expense for banks.

4. Property Administration

As a mortgagee of the property, the banks need to maintain property account, administer it and collect rent of land and building.

5. Legal Formalities

There are many legal formalities to be carried out in advancing against real estate like preparation of mortgage deed, its registration, stamp duty payment etc.

6. Delay in Realization

When the customer fails to repay the loan amount, the banker does not able to realize the property amount instantly, because there are many formalities involved in the sale of mortgaged property. The banker needs to wait for many months in order to get back the money.

7. Maintenance

The banker has to look after the mortgaged property and spend more on its maintenance when the customer fails to repay the loan amount.

Precautions in Advancing Against Real Estate

The following are the precautions need to be taken by the banker while advancing against real estate,

1. Title Verification

While advancing against real estates as security, the banker should verify the title deeds through its solicitors and find out whether the property is disputed or not.

2. Land Tenure Charges

The banker must have the knowledge of mortgaged property, whether the land is freehold, leasehold or state- owned and what are the charges involved in the tenure of land.

3. Property Valuation

The banker must appoint expert valuers to value the property because he may not able to value the mortgaged property carefully. The valuation involves,

- (i) Property location
- (ii) Right of ownership
- (iii) Rental value
- (iv) Type of construction
- (v) Land size and structure.

4. Insurance Cover

The bank should confirm whether the mortgaged property has a insurance cover against fire and other calamities. The policy must be assigned in favour of bank only.

5. Margin

The banker must keep a 50% to 60% margin of the real value of property as security while granting loan against real estates as security. For example, if the value of the property is ₹ 6000/- the bank must grant loan of ₹ 3000/- or less than that in order to avoid risks.

6. Legal Mortgage

Sec. 59 of the Transfer of Property Act, 1882 states that a 100 rupees mortgage deed need to be prepared and get registered with the registrar of companies within 30 days of their creation. Such deed must be signed by the Mortgagor along with two witness.

7. Tax and Rent Payment

Before granting loan against real estates as security, the banker must get all the rent payments and tax payments receipts of property from the customer along with the title deeds and verify whether all dues are cleared or not.

8. Clearance of Income Tax

The banker must get the property clearance certificate from the customer issued by the income tax office. According to Sec. 230 (A) of Income Tax Act, 1961, registration of property (apart from agricultural land) is to be valued at above ₹ 50,000/-.

3.6.1.5 Precautions to be taken while Advancing Loans Against Insurance Policies**Q28. What are the precautions to be taken loans against insurance policies ?**

Ans :

"A life insurance contract is a contract between an insurance company and a person called assured, whereby, the insurance company agrees to pay a certain sum on the happening of a certain event viz., death; (in the whichever is earlier (in the case of endowment policy). The consideration of this contract is that the assured agrees to pay a certain sum either in one lump sum called annuity or in installments called premium.

A life policy gives protection to the family members in the case of untimely death, and at the same time, it acts as a sort of investment, if death does not occur. Loans can be obtained from the life insurance company in times of need against the security of the policy.

Precautions

If the following precautions are taken into account, life policies can be very well accepted by banker:

1. Policy in Force

First of all, the banker should see whether the policy is in force or not. In other words, the policy should not have been lapsed. He must see that the premiums have been paid up to-date. It can be verified by means of checking the latest premium receipts. The borrower should be asked to submit the premium receipt as and when the premium is paid.

2. Extent of Surrender Value

Before granting any advances, the banker should ascertain the surrender value of from

the insurance company. Now-a-days, bankers can ascertain the surrender value at their own end by going through the "Programmed Manual" supplied by the life. Insurance Corporation of India the banker should maintain 10% to 15% margin of this surrender value, as a provision for safety.

3. Existence of Insurable Interest

The banker should also ensure that the borrower has an insurable interest. There is no problem if the policy is taken on his own life. But, if it is taken on the life of a third party, the banker must be very careful. Generally, in business, one partner can have insurable interest on the life of another partner. Similarly, the creditor has an insurable interest on the life of the debtor. In other cases, the existences of insurable interest are doubtful.

4. Admission of Age

The premium to be paid depends upon the age of the person, whose life has been insured. Hence, at the time of taking out the policy, the age of the assured should have been admitted by the company. If not, problems would arise at the time settling the claims. Hence, the banker should verify whether the age is admitted by the company. If not, problems would arise at the time of settling the claims. Hence, the banker should verify whether the age is admitted by the company or not. This fact is explicitly given on the policy itself. He should not accept policies where the age has not been admitted.

5. Preference to Endowment Policy with Profit

As between a whole life policy and an endowment policy, the banker should prefer an endowment policy; because, it matures within a stipulated period and the banker is very definite about the source of repayment. Even among endowment policies, he should prefer endowment policies with profit, because, bonuses are added every year to the policy amount.

6. Existence of Prior Encumbrance

The existence of any prior charge on the policy would affect the banker's interest. Hence, he should ascertain from the company that there are no encumbrances on the policy. Sometimes, the company itself would have granted loans on the policy. It can be found out by making an enquiry with the company. Normally, in such cases, the original policy will be with the company only.

7. Proper care in Creation of Charge

A charge may be created on the life policy either by a legal charge. Loans can be obtained by simply depositing the policy with the banker. It is case of equitable charge. In such a case, the banker must get a mandate along with the deposit of the policy. This mandate contains clauses in favour of the banker. However, the banker has to face some difficulties at the time of realization of the policy.

To avoid this, most of the bankers prefer a legal charge. It means that, the banker should get the policy assigned in his favour. This assignment can be made either on the policy itself or by a separate duly stamped document. A notice of assignment must, be given to the company, which will register the assignment in its books. A legal charge is always preferable, since, the banker does not face any difficulties in realizing the security, in case the borrower makes any default.

3.6.1.6 Precautions to be taken while Advancing Loans Against Collateral Securities

Q29. What is collateral securities ? and what are the precautions to be taken loans against collateral securities.

Ans :

Collateral Security

Collateral security is the security which is not primary security. Collateral means, secondary or additional, that means, collateral security is taken by lenders in addition to primary security to secure loan. Generally a property or other asset (like land, building, shares etc.) are taken lender to secure the loan.

Advances of Against Colateral Securities

Now-a-days, most of the loans are secured against goods. 'Goods' is a broader term which includes food products, raw materials, agricultural products and manufactured products including minerals. Advances against goods are mainly granted for working capital requirements of business and industries.

Precautions

In view of the above drawbacks, a banker should be very cautions while granting advances against goods. He should take the following precautions.

1. Character of the Borrower

First of all the banker should take into account the honesty, integrity and trustworthiness of the borrower: It is so because, a man of good character will not indulge in fraudulent activities like adulteration, use of false weights, measures etc.

2. Experience in the business

The banker should also find out whether the borrower has sufficient experiences in the particular trade in which he has engaged himself in. Only experienced person can know the risks involved in a business, and also, the profitable areas of the business. It is always risky to deal with inexperienced persons.

3. Purpose of the Loan

The banker must enquire into the purpose for which the loan is sought. The repayments of any loan depends upon the purpose for which it is required. If the loan is asked for speculation, black marketing and hoarding, a banker should never entertain it. On the other hand, if it is demanded for productive purposes or for preparing the goods for resale, loans can be granted without any hesitation.

4. Title of Borrower

The banker should ascertain whether the borrower has a genuine title to the goods. This can be done by verifying the invoices or cash receipts.

5. Nature of goods

The banker should pay a special attention to the nature of goods as well. Some of the goods are such, that. Their prices go up when they are in stock for long periods. Example, costly wood, costly rice etc., some of the goods cannot be stored for long, since, their quality is very much affected. Here, a banker should prefer only those goods which are not subject to deterioration in quality and which are easily realizable.

6. Proper Valuation of Goods

Adequate care should be taken to value the goods. It is on this basis of valuation, margin is fixed. Hence, a banker can appoint even experts to value the goods. He should not be carried away by-invoice prices, since, they might be inflated. So, he should actually compare the prices quoted in the bill with the prices prevailing in the market.

7. Prices in Different Markets

The prices prevailing in different markets will have a tendency to affect the prices in the local market. Hence, while regulating the margin, the banker should take into account, the prices prevailing in other markets also.

8. Proper Storage

Necessary care should be taken to see that the pledged goods are properly stored. As far as possible, the godowns should be situated near the bank, so that, the banker can have an easy access to it for inspection. Moreover, the goods must be arranged in such a way, it facilitates easy inspection. The goods must be fully protected from damages due to rain, fire, theft and dampness etc.

9. Care in a rented godown

If the goods are stored in a rented godown, the banker must establish his prior lien with the owner of the building by means of an agreement. Otherwise, the owner will have a prior lien over the goods in respect of the rent charges due.

10. Bank's Name Board

The godown containing pledged goods must

be locked by the bank's padlock. The bank's name board, reading "Goods pledged to - Bank", should be affixed permanently outside the godown in a prominent place.

11. Godown keys

The godown keys must be handled very carefully. On no account, they should be handed over to the customer. They should be kept in a strong room under dual control. A responsible officer must be in charge of their taking out and their safe return to the bank.

12. Adequate Insurance

All goods subject to a charge must be insured up to the full market value of the goods. They must be insured against all possible risks. The policy and the premium receipt should be kept by the bank.

13. Periodical inspection

The banker should conduct periodical inspection to see that the quality and quantity of goods in stock tally with the record maintained by both the banker and the customer. If there is any discrepancy, the borrower should be put into task.

14. Strict supervision over the release of goods

Sometimes, the borrowers may be allowed to repay the loan in installments. In such a case, he should ensure that the goods released are only in proportion to the amount of loan repaid. Each release must be directly supervised by a responsible officer. In any account, the best goods should not be released first.

15. Take Delivery of Goods

The banker should take delivery of the goods before granting any loan. This delivery may be actual or constructive as started earlier.

16. To deal with the owner of goods

The banker should always deal with the owner of goods or agents in possession of goods, while creating a charge on goods. It is so because; a valid pledge can be created only by those people.

17. Short period advance

Loans against goods must be granted only for short periods, because, the value of goods is likely to fall due to deterioration in its quality.

18. RBI's Directives

The RBI often issues directives prescribing margins; on various goods. These margins and other stipulations in connection therewith, should be carefully followed by banks, while lending against goods.

3.6.1.7 Precautions to be taken while Advancing Loans Against Banking Receipts

Q30. Write a short note on advance against fixed deposit receipts. State the precautions to be taken by a banker while granting loans and advances against fixed deposits.

Ans :

When money deposited by a customer is not repayable on demand and is payable on the expiry of a specified period from the date of deposit such a deposit is called a 'Fixed Deposit'. The banker evidences a deposit by issuing a receipt known as fixed deposit receipt. Interest, is paid at regular intervals at a specified rate on such deposits. Banks usually permit depositors to borrow against the deposit. This security is certainly the most valuable, as the money represented by the receipt is already with the bank and there is no problem of valuation or enquiring the title, or the problem of storage and costs associated with storage.

Precautions

- (i) The banker should grant the advance only to the person in whose name the money is deposited banker should not advance against fixed deposit receipts of other banks. This is because the banker who has received the deposit will have a general lien over such monies. Even if the lending bank gives notice to the bank, which has received the deposit, the latter may even refuse to register the lien in favour of the lending bank
- (ii) If, the deposit is in joint names the request for loan must come from all of them.

- (iii) When the deposit receipt is taken as security, the banker should ensure that all the depositors duly discharge it on the back of the instrument, after affixing the appropriate revenue stamp. In addition to this, the banker should obtain a letter of appropriation which authorizes the banker to appropriate the amount of the deposit on maturity or earlier towards the loan amount.
- (iv) After granting the advance, the banker must note his lien in the fixed deposit register to avoid payment by mistake and the lien, must also be noted on the receipt itself.
- (v) Advance should preferably not be made against fixed deposit receipt in the name of a minor, unless a declaration is taken from guardian, that loan will be utilized for benefit of the minor.
- (vi) Where the money is being advanced against the fixed deposit receipt issued by another branch, the FDR duly discharged must be sent to the branch, where such money is deposited, for the following purposes:
 - (a) To verify the specimen signature of the depositor
 - (b) To ensure that no prior lien exists on the fixed deposit receipt
 - (c) To mark lien on the FDR and the FDR register, in favour of branch advancing money.
- (vii) Sometimes, a person may approach for advances by offering the fixed deposit receipts held by third parties as security. In such a case, the fixed deposit receipt must be duly discharged, by the third party, i.e., FD holder and he should declare in writing the bank's right to hold the deposit receipt as security, and also to adjust the deposit amount towards the loan account on maturity or on default in repayment of instalment if any.

Short Question and Answers

1. What is Negotiable Instruments ?

Ans :

Meaning

The word negotiable means 'transferable by delivery', and the word instrument means 'a written document by which a right is created in favour of some person'. Thus, the term "negotiable instrument" literally means "a written document transferable by delivery".

Definitions

1. **According to Section 13 (1) of the Negotiable Instruments Act**, "A negotiable instrument means a promissory note, bill of exchange, or cheque payable either to order or to bearer".
2. "A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one of two, or one or some of several payees" [Section 13(2)].
3. **According to Thomas**, "A negotiable instrument is one which is, by a legally recognized custom of trade or bylaw:
 - 1) Transferable by delivery or by endorsement and delivery
 - 2) Without notice to the party liable, in such a way that the holder of it for the time being may sue upon it in his own name and
 - 3) The property in it passes to a bona fide transferee for value free from equities and free from any defect in the title of the person from whom he obtained it.

This means that a person taking an instrument 'Bona fide', and 'For value', known as a holder in due course, gets a good title even though the title of the transferor may be defective.

2. Characteristics of promissory note.

Ans :

1) It is an Instrument in Writing

A mere verbal promise to pay is not a promissory note. The promise should be in writing. The writing may be in ink or pencil, or printing, engraving, or lithographing. It may be in any form, it will be a promissory note so long as it satisfies the other requirements of Section 4.

In other words, an oral promise does not make a promissory note since it is not an instrument.

2) It is a Promise to Pay

There must be an express undertaking or promise to pay. A mere acknowledgement of indebtedness or implied undertaking by the use of the word 'debt' or 'pro-note' is not sufficient and it does not constitute a promissory note.

3) Signed by the Maker

The instrument must be signed by the maker, otherwise it is incomplete and of no effect. Even if it is written by the maker himself and his name appears in the body of the instrument, his signature must be there. Signature means the writing of a person's name in order to authenticate and give effect to the contract contained in the instrument. It is, at the same time, essential that the mind of the signer must accompany the signature.

4) Other Formalities

The other formalities regarding number, place, date, consideration, etc., though usually found given in the promissory notes but are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case, omission of date does not invalidate the instrument if the date of execution can be independently ascertained.

and proved. The words "value received" is also unnecessary. But a promissory note must be properly stamped as required by the Indian Stamps Act. Each stamp must also be properly cancelled.

5) Definite and Unconditional Promise

The promise must be definite and unconditional. It may be noted that a promise to pay is not conditional if it depends upon an event which is certain to happen but the time of its occurrence may be uncertain.

3. Define bills of exchange.

Ans :

A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument (Sec. 5).

Parties There are three parties to bill of exchange, viz., the drawer, the drawee and the payee.

1. **Drawer** : The person who gives the order to pay or who makes the bill is called the drawer.
2. **Drawee** : When the drawee accepts the bill, he is called the acceptor (or) drawee.
3. **Payee** : The person to whom the payment is to be made is called the payee.

4. Define Cheque.

Ans :

Meaning and Definition of Cheque [Section 6]

Section 6 of the Negotiable Instruments Act, 1881 defines a cheque as "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand". A cheque is also, therefore, a bill of exchange with two additional qualifications:

- 1) It is always drawn on a specified banker.
- 2) It is always payable on demand.

All cheques are bills of exchange but bills are not cheques. A cheque must have all the essential requisites of a bill of exchange. It must be signed by

the drawer. It must contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a specified person or the bearer of the cheque. But it does not require acceptance as it is intended for immediate payment.

5. Explain the parties involved in cheque.

Ans :

Parties to Cheque

Parties of cheque are as follows :

1. **Drawer** : Drawer is the person who draws the cheque, i.e., the depositor of money in the bank.
2. **Drawee** : Drawee is the drawer's banker on whom the cheque has been drawn.
3. **Payee** : Payee is the person who is entitled to receive the payment of a cheque.

6. Define loans and advances.

Ans :

Loans and Advances

According to Section 5(n) of the Banking Act, 1949, a secured loan or advance is "loan or an advance made on the security of assets the market value of which is not at any time less than the amount of such loan or advance".

Loans and advances constitute by far the most important revenue of investment of banker's resources and are the principal source of profit. Other sources of income such as bank commission and charges are small.

7. Types of Loans and Advances.

Ans :

According to the needs and requirements of customers, commercial banks provide different types of loans and advances as follows,

1. Demand Loan

These loans are sanctioned against goods and documents of title of goods, banks own fixed deposits, gold ornaments. These loans are for short period.

2. Term Loan

- (a) 1 to 5 years medium term, 5 to 10 years long term.
- (b) A bank loan with a floating interest rate and which is repaid over a specific period of time i.e., from 1-10 years is known as term loan.

3. Cash Credit

Cash credit is one of the facility which is provided by the banker wherein, the borrower is allowed to withdraw the amount upto a particular limit. The customer's account is credited with the amount and he can make the withdrawals as per his needs. The bank usually charges interest on amount which is withdrawn and not on the complete amount which is being credited to the borrower's account. In cash credit, the banker clearly mentions a particular limit of loan for the customer, which is termed as cash credit limit. If suppose the customer maintains the account properly, then cash credit limit would be renewed by the bank at the year ending.

4. Overdraft

The term 'Overdraft' refers to the act of overdrawing from bank account. In overdraft, the account holder is enabled of withdrawn amount which is usually more than the credit balance in his/her account. This facility is basically given for a shorter period of time to those customers who carries out their transactions via Cheques. Overdraft facility is usually given on security on assets or on personal security.

5. Discounting of Bills of Exchange

Bill discounting is another type of facility which is usually provided by discounting the general trade bills i.e., doing the payment prior to the due date of bills and after excluding a particular discount rate. On due date, bank submits the bill to the borrower's customer and collects the complete amount. In case, if the bill is dishonoured then bank collects the amount along with interest from the borrower or his customers. Bill

discounting is an advance which is given for security of bill. Bank verifies the creditworthiness of drawer and genuineness of the bill before discounting it.

8. Precautions in Advancing Against Goods.

Ans :

The following precautions must be taken by a bank while granting advances against goods,

1. Borrower Character

The bank must consider the honesty, trustworthiness and integrity of the borrower at the time of granting advances against goods.

2. Experience of Borrower

The bank must check whether the borrower is an experience person in a particular business or not because dealing with an inexperienced person will be a risk for the banks.

3. Title to the Goods

The bank must find out the borrower's genuine title to the goods through cash receipts or invoices.

4. Nature of Goods

The bank must also consider the nature of the goods. It should prefer only those goods which can be stored for longer period of time and easily realizable goods.

5. Purpose of Loan

The bank should also find out the reason why customer is taking a loan against goods. The loan is provided only for the productive purposes and for the resale of goods.

6. Valuation of Goods

Goods are valued with proper care and even an expert will be appointed to value the goods. He must compare the prevailing prizes and prices quoted in the bill at the time of valuation of goods.

7. Insurance

Goods must be insured with the full market value and against all possible risks. The receipt of such policy/premium is with the bank only.

9. What is collateral securities ?

Ans :

Collateral Security

Collateral security is the security which is not primary security. Collateral means, secondary or additional, that means, collateral security is taken by lenders in addition to primary security to secure loan. Generally a property or other asset (like land, building, shares etc.) are taken lender to secure the loan.

Advances of Against Colateral Securities

Now-a-days, most of the loans are secured against goods. 'Goods' is a broader term which includes food products, raw materials, agricultural products and manufactured products including minerals. Advances against goods are mainly granted for working capital requirements of business and industries.

10. Write a short note on advance against fixed deposit receipts.

Ans :

When money deposited by a customer is not repayable on demand and is payable on the expiry of a specified period from the date of deposit such a deposit is called a 'Fixed Deposit'. The banker evidences a deposit by issuing a receipt known as fixed deposit receipt. Interest, is paid at regular intervals at a specified rate on such deposits. Banks usually permit depositors to borrow against the deposit. This security is certainly the most valuable, as the money represented by the receipt is already with the bank and there is no problem of valuation or enquiring the title, or the problem of storage and costs associated with storage.

Choose the Correct Answer

1. _____ is special kind of bailment. [a]
(a) Pledge (b) Agency
(c) Contract (d) Agreement
2. A seller who has not been paid the whole price of the goods sold is known as [b]
(a) Paid seller (b) Unpaid seller
(c) Yet to pay seller (d) Post paid seller.
3. _____ are rules, regulations and by-laws for the internal management of the affairs of a company. [c]
(a) Memorandum (b) Contract
(c) Articles (d) Negotiable instruments
4. The person to whom goods are delivered under a contract of bailment is [d]
(a) Bailer (b) Pledger
(c) Seller (d) Bailee
5. Advances against _____ are short term in nature. [c]
(a) Real estate (b) Life policy
(c) Goods (d) stock
6. The person who gives the guarantee is called _____. [b]
(a) Creditor (b) Surety
(c) Debtor (d) Agent
7. When a cheque bears in addition of the name of a Banker then it is called as [c]
(a) General crossing (b) Restrictive crossing
(c) Special crossing (d) Bill of exchange
8. Promissory note have _____ parties [d]
(a) Three (b) One
(c) Six (d) Two
9. It is very difficult to ascertain the title in the case of [a]
(a) Land and Building (b) Stock Exchange securities
(c) Life policies (d) Shares of private companies
10. The finder of goods possess the following right [c]
(a) Right to possess goods (b) Right to sue trespassers
(c) Right to sale (d) Right to claim damages.

Fill in the blanks

1. The word negotiable means _____ .
2. _____ mean the instruments in which time for payment is mentioned.
3. _____ is the person to whom the amount of the note is payable.
4. The person who gives the order to pay or who makes the bill is called the _____ .
5. When the drawee accepts the bill, he is called the _____ .
6. _____ acceptance is the one, where a bill is accepted with certain conditions or qualifications and the effect of the bill gets changed from the way it had been originally drawn.
7. A cheque which can be withdrawn at the counter of the bank is called _____ .
8. A _____ banker is one who undertakes to collect the amount of a cheque for his customer from the paying banker.
9. When the drawee is unable to make payment on the due date then the cheque becomes _____ .
10. When money deposited by a customer is not repayable on demand and is payable on the expiry of a specified period from the date of deposit such a deposit is called a _____ .

ANSWERS

1. transferable by delivery
2. Time instruments
3. Payee
4. drawer
5. acceptor
6. Qualified
7. open cheque
8. collecting
9. bounced
10. Fixed Deposit

UNIT IV

Introduction to Financial Services:

Financial Services: Meaning – Functions – Classification - Scope - Fund Based Activities - Non-fund Based Activities - Modern Activities - Causes for Financial Innovation - New Financial Products and Services - Innovative Financial Instruments - Challenges Facing the Financial Service Sector -Present Scenario

4.1 INTRODUCTION TO FINANCIAL SERVICES

4.1.1 Meaning

Q1. Define the term Financial Services. What are the characteristics of Financial Services.

Ans :

Introduction

The Indian financial services industry has undergone a metamorphosis since 1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry.

In fact, one of the world's largest industries today is the financial services industry.

Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation.

Meaning of Financial Services

In general, all types of activities which are of financial nature may be regarded as financial services.

- In a broad sense, the term financial services means mobilisation and allocation of savings.
- Thus, it includes all activities involved in the transformation of savings into investment.
- Financial services refer to services provided by the finance industry.

- The finance industry consists of a broad range of organisations that deal with the management of money.
- These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.
- Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.
- Financial services can also be called financial intermediation.
- Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers.
- There are various institutions which render financial services.
- Some of the institutions are banks, investment companies, accounting firms, financial institutions, merchant banks, leasing companies, venture capital companies, factoring companies, mutual funds etc.
- These institutions provide variety of services to corporate enterprises. Such services are called financial services.
- Thus, services rendered by financial service organisations to industrial enterprises and to ultimate consumer markets are called financial services.

- These are the services and facilities required for the smooth operation of the financial markets.
- In short, services provided by financial intermediaries are called financial services.

Characteristics (or) Nature of Financial Services

From the following characteristics of financial services, we can understand their nature:

1. Intangibility

Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

2. Inseparability

Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect understanding between the financial service institutions and its customers.

3. Perishability

Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

4. Variability

In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers. The service institutions differentiate their services to develop their individual identity.

5. Dominance of human element

Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled

personnel to market the quality financial products.

6. Information based

Financial service industry is an information based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

Q2. Explain the evolution of financial services in India.

Ans :

Evolution of Financial Services In India financial services sector is blooming in India and it has passed through various phases as mentioned below:

- i) Initial phase (1960-80)
- ii) Second phase (1980-90)
- iii) Third phase (1990-2002)

i) Initial phase

Financial services at the initial phase introduced many innovative services such as merchant banking, Insurance and leasing finance. The term merchant banking was not known till 1960. It was used as an umbrella function. Its activities start from project appraisal to mobilization of finance from suppliers. They also underwrote the public issues and helped in getting the shares listed in the stock exchange. LIC, GIC and UTI initiated to enter into this segment during this period. Leasing activities was started in the year 1970. Initially leasing companies were engaged in equipment lease financing. Afterwards they have undertaken different kinds of leasing such as financial lease, operating lease and wet leasing.

ii) Second phase

Financial services entered the second stage and it covered the period of 10 years approximately. In this phase it introduced many innovative value added services such as over the counter share transfers, pledging of shares, mutual funds, factoring, discounting, venture capital and credit rating.

Mutual funds provide major fund to the industry anywhere in the developed countries. Credit rating reduces malpractices in the capital market and this rating is applied only to debt instruments only. Now this rating is mandatory for commercial papers and fixed deposits.

iii) Third phase

This phase in financial services include the setting up of new institutions and instruments. This period started after post liberalization. The depositories, the stock lending schemes, online trading, paperless trading, dematerialization, book buildings are the contemporary issues of this phase. This phase has initiated to popularize book building to help both investors and fund mobilizes. In this phase government has taken initiatives to allow foreign institutional investors into the capital market. The government of India is revamping companies' act, income tax act, MRTP act etc, for delivering effective financial services.

Q3. Explain the importance of financial services.

Ans :

Importance of Financial Services

The successful functioning of any financial system depends upon the range of financial services offered by financial service organisations. The importance of financial services may be understood from the following points:

1. Economic growth

The financial service industry mobilises the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. Promotion of savings

The financial service industry mobilises the savings of the people by providing transformation services. It provides liability, asset and size transformation service by

providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. Capital formation

Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. Creation of employment opportunities

The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. Contribution to GNP

Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

6. Provision of liquidity

The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

4.1.2 Functions of financial services

Q4. What are the functions of Financial Services.

Ans :

1. Fund Raising

Raising funds is the primary function of financial services. It raises funds from investors, individuals and institutions through a wide range of instruments. The funds raised are again made available to the need individuals, corporate and institutions.

2. Funds Deployment

Financial services help in effective and optimum deployment of funds raised. A major function of financial services is assisting in deciding to optimum financing mix for their corporate clients. Financial services aims at efficient usage of funds through parking of short term funds in the money market, securitisation of debts, bill discounting, factoring etc.

3. Specialisation

Specialised services like credit research and credit rating, leasing, venture factoring capital financing, book building etc., are also performed by financial services besides the regular banking and insurance functions. Stock exchanges, specialised and general financial institutions, non-banking also provides these services.

4. Economic Growth

It also performs the function of accelerating economic growth through mobilisation of savings. Financial services aims at developing an economy through channelising the savings into profitable investments. Higher rates of savings and investments characterize developed economies.

5. Regulation

Financial services activities have been found to be regulated by SEBI, RBI and the development of banking and insurance of government of India, through names and rules of legislations.

4.1.3 Classification of financial services**Q5. Explain the different types of Financial Services.**

Ans :

When money deposited by a customer is not repayable on demand and is payable on the expiry of a specified period from the date of deposit such a deposit is called a 'Fixed Deposit'. The banker evidences a deposit by issuing a receipt known as fixed deposit receipt. Interest, is paid at regular intervals at a specified rate on such deposits. Banks usually permit depositors to borrow against the deposit. This security is certainly the most valuable, as the money represented by the receipt is already with the bank and there is no problem of valuation or enquiring the title, or the problem of storage and costs associated with storage.

Precautions

- (i) The banker should grant the advance only to the person in whose name the money is deposited banker should not advance against

fixed deposit receipts of other banks. This is because the banker who has received the deposit will have a general lien over such monies. Even if the lending bank gives notice to the bank, which has received the deposit, the latter may even refuse to register the lien in favour of the lending bank

- (ii) If, the deposit is in joint names the request for loan must come from all of them.
- (iii) When the deposit receipt is taken as security, the banker should ensure that all the depositors duly discharge it on the back of the instrument, after affixing the appropriate revenue stamp. In addition to this, the banker should obtain a letter of appropriation which authorizes the banker to appropriate the amount of the deposit on maturity or earlier towards the loan amount.
- (iv) After granting the advance, the banker must note his lien in the fixed deposit register to avoid payment by mistake and the lien, must also be noted on the receipt itself.
- (v) Advance should preferably not be made against fixed deposit receipt in the name of a minor, unless a declaration is taken from guardian, that loan will be utilized for benefit of the minor.
- (vi) Where the money is being advanced against the fixed deposit receipt issued by another branch, the FDR duly discharged must be sent to the branch, where such money is deposited, for the following purposes:
 - (a) To verify the specimen signature of the depositor
 - (b) To ensure that no prior lien exists on the fixed deposit receipt
 - (c) To mark lien on the FDR and the FDR register, in favour of branch advancing money.
- (vii) Sometimes, a person may approach for advances by offering the fixed deposit receipts held by third parties as security. In such a case, the fixed deposit receipt must be duly discharged, by the third party, i.e., FD holder

and he should declare in writing the bank's right to hold the deposit receipt as security, and also to adjust the deposit amount towards the loan account on maturity or on default in repayment of instalment if any

4.2 SCOPE OF FINANCIAL SERVICES

4.2.1 Fund Based Activities, Non-fund Based Activities and Modern Activities

Q6. Explain the scope of Financial Services.

Ans :

Financial services cover a wide range of activities. They can be broadly classified into two namely:

- (i) Traditional activities
- (ii) Modern activities

(i) Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

- (a) Fund based activities and
- (b) Non-fund based activities.

(a) Fund based activities

The traditional services which come under fund based activities are the following :

- (i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)
- (ii) Dealing in secondary market activities.
- (iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
- (iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.
- (v) Dealing in foreign exchange market activities.

(b) Non-fund based activities

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

- (i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.
- (ii) Making arrangements for the placement of capital and debt instruments with investment institutions.
- (iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.
- (iv) Assisting in the process of getting all Government and other clearances.

(ii) Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

- (i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.
- (ii) Planning for mergers and acquisitions and assisting for their smooth carry out.
- (iii) Guiding corporate customers in capital restructuring.
- (iv) Acting as Trustees to the debenture-holders.
- (v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

- (vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.
- (vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.
- (viii) Hedging of risks due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.
- (ix) Managing the portfolio of large Public Sector Corporations.
- (x) Undertaking risk management services like insurance services, buy-back options etc.
- (xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.
- (xii) Guiding the clients in the minimisation of the cost of debt and in the determination of the optimum debt-equity mix.
- (xiii) Undertaking services relating to the capital market such as:
 - (a) Clearing services,
 - (b) Registration and transfers,
 - (c) Safe-custody of securities,
 - (d) Collection of income on securities.
- (xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

4.3 CAUSES FOR FINANCIAL INNOVATION

Q7. State the causes for financial innovation in the financial service sector?

Ans :

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

(i) Low profitability

The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition

The entry of many financial intermediaries in the financial sector market has led to severe competition among themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic liberalisation

Reform of the financial sector constitutes the most important component of India's programme towards economic liberalisation. The recent economic liberalisation measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival

(iv) Improved communication technology

The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer service

Nowadays, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations thus help them in soliciting new business.

(vi) Global impact

Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

(vii) Investor awareness

With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

4.4 NEW FINANCIAL PRODUCTS AND SERVICES**Q8. Explain the various New Financial Products and Services.**

Ans :

Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberalization policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and services so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products

and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly discussed below:

(i) Merchant Banking

A merchant banker is a financial intermediary who helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customers securities, portfolio management, project counselling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) Loan Syndication

This is more or less similar to 'consortium financing'. But, this work is taken up by the merchant banker as a lead- manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

(iii) Leasing

A lease is an agreement under which a company or a firm, acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. He is expected to pay for all maintenance charges and repairing

and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

(iv) Mutual Funds

A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimising risk. The fund provides investment avenue for small investors who cannot participate in the equities of big companies. It ensures low risks, steady returns, high liquidity and better capital appreciation in the long run.

(v) Factoring

Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a del credere agent who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

(vi) Forfaiting

Forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfaitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

(vii) Venture Capital

A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services

It is yet another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

(ix) Corporate Advisory Services

Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers so that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

(x) Securitisation

Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which

are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. It is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) **Derivative Security**

A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of traded securities. A derivative security is basically used as a risk management tool and it is resorted to cover the risks due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation. Example: Forwards in forex market.

(xii) **New Products in Forex Market**

New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones:

(a) Forward Contracts: A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for, e.g.,

31st May or a flexible maturity for, e.g., 1st to 31st May. There is an obligation to honour this contract at any cost, failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) Options: As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are much restrictions in India.

(c) Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. It can be dealt only in a stock exchange.

(d) Swaps : A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus, swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also. It is explained in detail under the chapter derivatives.

(xiii) Letter of Credit (LOC)

It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of a financing institution/bank of one country with another institution/bank/agent to support the export of goods and services so as to enable the importers to import on deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

4.5 INNOVATIVE FINANCIAL INSTRUMENTS

Q9. Discuss briefly some of the Innovative Financial Instruments introduced in recent times in the financial service sector.

Ans :

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been briefly discussed hereunder:

(i) Commercial Paper

A commercial paper is a short-term negotiable money market instrument. It has the

character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.

(ii) Treasury Bill

A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-days bills and 364-days bills.

(iii) Certificates of Deposit

The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

(iv) Inter-bank Participations (IBPs)

The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be 'with risk' participation or 'without risk' participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.

(v) Zero Interest Convertible Debenture/ Bonds

As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.

(vi) Deep Discount Bonds

There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs. 2,00,000 was issued at a deep discounted price of Rs. 5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

(vii) Index-Linked Gilt Bonds

These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.

(viii) Option Bonds

These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically.

This option has to be exercised by the prospective investor at the time of investment.

(ix) Secured Premium Notes

These are instruments which carry no interest for three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

(x) Medium Term Debentures

Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

(xi) Variable Rate Debentures

Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

(xii) Non-Convertible Debentures with Equity Warrants

Generally debentures are redeemed on the date of maturity. But, these debentures are redeemed in full at a premium in instalments as in the case of anticipated insurance policies. The instalments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.

(xiii) Equity with 100% Safety Net

Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs. 40/- per share (nominal value of Rs. 10/- per share), the company is ready to get it back at Rs. 40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs. 30/- there is 100% safety net and hence the company will get it back at Rs. 40/-.

(xiv) Cumulative Convertible Preference Shares

These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

(xv) Convertible Bonds

A convertible bond is one which can be converted into equity shares at a pre-determined timing either fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally

convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

Example: In June 1989, the Tata Iron and Steel Company issued 30 lakhs partly convertible debentures of Rs. 1200 each for cash at par with the following terms:

- (i) Conversion of Rs. 600 par value into one equity share of Rs.100 at a premium of Rs. 500 on Feb. 1, 1990,
- (ii) Interest rate of 12% per annum, and
- (iii) Redemption of the non-convertible portion at the end of 8 years.

(xvi) Debentures with 'Call' and 'Put' Feature

Sometimes debentures may be issued with 'Call' and 'Put' feature. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.

(xvii) Easy Exit Bond

As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs.5000 per bond. Interest is payable half yearly at the rate of at least 2.5% p.a. over the State Bank of India's 3 year Fixed deposit rate at any time or 1.5% p.a. above the interest rate on 10 year Government Bonds.

(xviii) Retirement Bond

This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period.' The longer the wait period, the higher will be the monthly income. Besides

these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond '96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.

(xix) Regular Income Bond

This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond '96 carrying 16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

(xx) Infrastructure Bond

It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec.88, Sec.54 EA and Sec. 54 EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is Rs. 1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.

(xxi) Carrot and Stick Bonds

Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

(xxii) Convertible Bonds with a Premium put

These are bonds issued at face value with a put, which means that the bondholder can redeem the bonds for more than their face value.

(xiii) Debt with Equity Warrant

Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.

(xiv) Dual Currency Bonds

Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.

(xv) ECU Bonds (European Currency Unit Bonds)

These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.

(xvi) Yankee Bonds

If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.

(xvii) Flip-Flop Notes

It is a kind of debt instrument which permits investors to switch between two types of securities — e.g., to switch over from a long-term bond to a short-term fixed-rate note.

(xviii) Floating Rate Notes (FRNs)

These are debt instruments which facilitate periodic interest rate adjustments.

(xxix) Loyalty Coupons

These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

(xxx) Global Depository Receipt (GDR)

A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A. or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

4.6 CHALLENGES FACING THE FINANCIAL SERVICE SECTOR
Q10. What are the Challenges Faced by the Financial Service Sector ?

Ans :

The financial service sector has to face many challenges in its attempt to raifill the ever growing financial demands of the economy. Some of the important challenges are briefly reported hereunder:

(i) Lack of qualified personnel

The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and a comprehensive training must be given to the various financial intermediaries.

(ii) Lack of investor awareness

The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.

(iii) Lack of transparency

The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.

(iv) Lack of specialisation

In the Indian scene, each financial intermediary seems to deal in different

financial service lines without specialising in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons, Solomon Brothers etc. specialise in one or two areas only. This helps them to achieve high levels of efficiency and excellence. Hence, in India also, financial intermediaries can go for specialisation.

(v) Lack of recent data

Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'. Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

(vi) Lack of efficient risk management system

With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilisation of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfil the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

4.7 PRESENT SCENARIO OF FINANCIAL SERVICES

Q11. Critically analyse the present position of the financial service sector in India.

Ans :

(i) Conservatism to dynamism

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our country. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. The aggregate funds raised by the industries in the primary markets have gone from Rs. 61 billion in 1991-92 to Rs. 126 billion in 1993-94. The number of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 7000 in 1993. Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating

There is every possibility of introducing Equity Grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, Equity Grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, Grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

- (i) Credit Rating Information Services of India Ltd. (CRISIL)
- (ii) Credit Analysis and Research Ltd. (CARE) and
- (iii) Investment Information and Credit Rating Agency (ICRA).
- (iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India).

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalisation

Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

(v) Process of Liberalisation

Realising all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issues from pricing issues by the Controller of capital issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatised. The Finance Act, 1992 has brought into effect large scale amendments in the tax structure of long-term capital gains. The Finance Act, 1994 has given a further boost by lowering the lock-in period from 3 years to 1 year, in order to get the entitlement as a long-term capital asset. The Securities Exchange Board of India has liberalised many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

Short Question and Answers

1. Define the term Financial Services.

Ans :

The Indian financial services industry has undergone a metamorphosis since 1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry.

In fact, one of the world's largest industries today is the financial services industry.

Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation.

Meaning of Financial Services

In general, all types of activities which are of financial nature may be regarded as financial services.

- In a broad sense, the term financial services means mobilisation and allocation of savings.
- Thus, it includes all activities involved in the transformation of savings into investment.
- Financial services refer to services provided by the finance industry.
- The finance industry consists of a broad range of organisations that deal with the management of money.
- These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.
- Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

2. Importance of Financial Services

Ans :

1. Economic growth

The financial service industry mobilises the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. Promotion of savings

The financial service industry mobilises the savings of the people by providing transformation services. It provides liability, asset and size transformation service by providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. Capital formation

Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. Creation of employment opportunities

The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. Contribution to GNP

Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

3. Fund based activities

Ans :

The traditional services which come under fund based activities are the following :

- (i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)

- (ii) Dealing in secondary market activities.
- (iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
- (iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.
- (v) Dealing in foreign exchange market activities.

4. Non-fund based activities.

Ans :

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

- (i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.
- (ii) Making arrangements for the placement of capital and debt instruments with investment institutions.
- (iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.
- (iv) Assisting in the process of getting all Government and other clearances.

5. Modern activities.

Ans :

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

- (i) Rer iering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.

- (ii) Planr ing for mergers and acquisitions and assisting for their smooth carry out.
- (iii) Guiding corporate customers in capital restructuring.
- (iv) Acting as Trustees to the debenture-holders.
- (v) Recommending suitable changes in the management structure and management style with a view to achieving better results.
- (vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.
- (vii) Rehabilitating and reconstructing sick companies through appro-priate scheme of reconstruction and facilitating the implementation of the scheme.
- (viii) Hedging of risks due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.
- (ix) Managing the portfolio of large Public Sector Corporations.
- (x) Undertaking risk management services like insurance services, buy-back options etc.
- (xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

6. Letter of Credit (LOC).

Ans :

It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of a financing institution/bank of one country with another institution/bank/agent to support the export of goods and services so as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the

financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

7. Deep Discount Bonds.

Ans :

There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs. 2,00,000 was issued at a deep discounted price of Rs. 5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

8. Cumulative Convertible Preference Shares.

Ans :

These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

9. Convertible Bonds.

Ans :

A convertible bond is one which can be converted into equity shares at a per-determined timing either fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

Example: In June 1989, the Tata Iron and Steel Company issued 30 lakhs partly convertible

debentures of Rs. 1200 each for cash at par with the following terms:

- (i) Conversion of Rs. 600 par value into one equity share of Rs.100 at a premium of Rs. 500 on Feb. 1, 1990,
- (ii) Interest rate of 12% per annum, and
- (iii) Redemption of the non-convertible portion at the end of 8 years.

10. Credit Rating.

Ans :

There is every possibility of introducing Equity Grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, Equity Grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, Grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

- (i) Credit Rating Information Services of India Ltd. (CRISIL)
- (ii) Credit Analysis and Research Ltd. (CARE) and
- (iii) Investment Information and Credit Rating Agency (ICRA).
- (iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India).

Their activities have been mainly confined to debt instruments only.

Choose the Correct Answer

1. The following one is a kind of fee based activity of a financial intermediary, [c]
(a) Hirepurchase financing (b) Leasing
(c) Capital issue management (d) Underwriting of shares.
2. Find the odd man out: [b]
(a) Commercial paper (b) Share certificate
(c) Certificate of deposit (d) Treasury bill.
3. The process of managing the sales ledger of a client by a financial service company is called: [b]
(a) Forfeiting (b) Factoring
(c) Leasing (d) Securitisation of debt.
4. The inflation free instrument is: [b]
(a) Option bond (b) Index-linked gilt bond
(c) Variable rate debenture (d) Deep discount bond.
5. Non-banking companies should compulsorily get credit rating for their: [c]
(a) Capital market instruments (b) Money market instruments
(c) Debt market instruments (d) All of the above.
6. Financial service institutions pool up savings of small investors to raise funds is [a]
(a) Mutual funds (b) Factoring
(c) Leasing (d) Hire purchase
7. In India, the challenges faced by financial service sector are [d]
(a) No transparency (b) Outdated database
(c) Need for specialisation (d) All the above
8. Bonds which ensure monthly income for the investor after a fixed 'wait period' are [b]
(a) Convertible bonds (b) Retirement bonds
(c) Easy exit bonds (d) Option bonds
9. Transfer of funds from those who have it to those who need it is allowed in [c]
(a) Leasing (b) Forfeiting
(c) Merchant banking (d) Factoring
10. New products in forex markets of developed countries are [d]
(a) Forwards (b) Options
(c) Futures (d) All the above

11. Which of the following is not a fund-based activity [b]
(a) Underwriting of shares
(b) Capital issue management
(c) Underwriting of secondary market securities
(d) Foreign exchange activities
12. The capital market involves [c]
(a) Primary market (c) Both (a) and (b)
(d) All the above (d) Money market
13. The recent trends in the financial service sector in India are influenced by growth and development of [d]
(a) Commercial banks (b) Regional rural banks
(c) Insurance sector (d) All the above
14. Financial intermediaries add economies to the financial instruments to suit the requirements of investors in the form of [c]
(a) Convenience (b) Expert management
(c) Both (a) and (b) (d) High risk
15. Bonds which are issued in one currency and redeemable in another currency are [b]
(a) Samurai bonds (b) Dual currency bonds
(c) Infrastructure bonds (d) Option bonds.

Fill in the blanks

1. The important goal of the financial service industry is to mobilise and allocate _____ .
2. Underwriting of shares by a financial intermediary is a kind of _____ activity.
3. _____ services are mainly provided to foreign investors.
4. _____ bonds are sold at a large discount to their nominal value.
5. To regulate the securities market and to protect the investor's interest. _____ has been created by the Government of India.
6. Term lending institutions are _____ market intermediaries.
7. In _____ dealings of financial claims take place and prices are set depending upon the demand of the funds and their requirements by the investors.
8. _____ have been providing a wide range of services to both capital and money market.
9. A money market instrument issued by government at discount and redeemed at par is known as _____ .
10. Debt instruments that allow investors to shift between two different types of securities is _____ .
11. Market for extremely short period loans (1-14) days is considered as _____ .
12. _____ is a debt instrument that aids in managing periodic interest rates.
13. _____ is an act of creating and popularizing new financial instruments as well as new financial technologies, institutions and markets.
14. The bonds that can be encashed anytime after 18 months of the issue date is _____ .
15. Bonds that are raised in U.S.A is _____ .
16. _____ implies assuming credit risk in the collection of book debts for the clients.

ANSWERS

1. Savings
2. Fund based
3. Custodial
4. Deep discount
5. SEBI
6. Capital
7. Financial markets
8. Financial intermediaries
9. Treasury bill
10. Flip-flop notes
11. Call money market
12. Floating rate notes
13. Financial innovation
14. Easy exit bond
15. Yankee bonds
16. Factoring

UNIT V

Financial Services:

Definition - Services of Merchant Banks - Problems and Scope of Merchant Banking in India - Venture Capital: Meaning, Features, Scope, Importance - Leasing - Definition and Steps - Types of Lease - Financial Lease - Operating Lease - Leverage Lease - Sale and Lease Back - Discounting: Concept - Advantages of Bill Discounting - Factoring - Meaning and Nature - Parties in Factoring - Merits and Demerits of Factoring - Forfeiting - Parties to Forfeiting - Costs of Forfeiting - Benefits of Forfeiting for Exporters and Importers

5.1 MERCHANT BANKING

5.1.1 Definition

Q1. Define the term Merchant Banking.

Ans :

Meaning

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services.

The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking. We can define merchant banking as a process of transferring capital from those who own it to those who use it.

Definition

- i) **According to Random House Dictionary**, "merchant bank is an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks".
- ii) **According to SEBI (Merchant Bankers) Rules 1992**, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering

corporate advisory services in relation to such issue management".

- iii) In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

Thus merchant banking involves a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, preparation of feasibility reports etc. It is not necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialise in one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

In short, merchant banking involves servicing any financial need of the client.

Q2. Describe briefly the evolution of Merchant Banking in India.

Ans :

Though it is non-banking financial activity but resembles banking function, originated in Europe.

The Dutch and Scottish merchants started financing foreign by accepting bills.

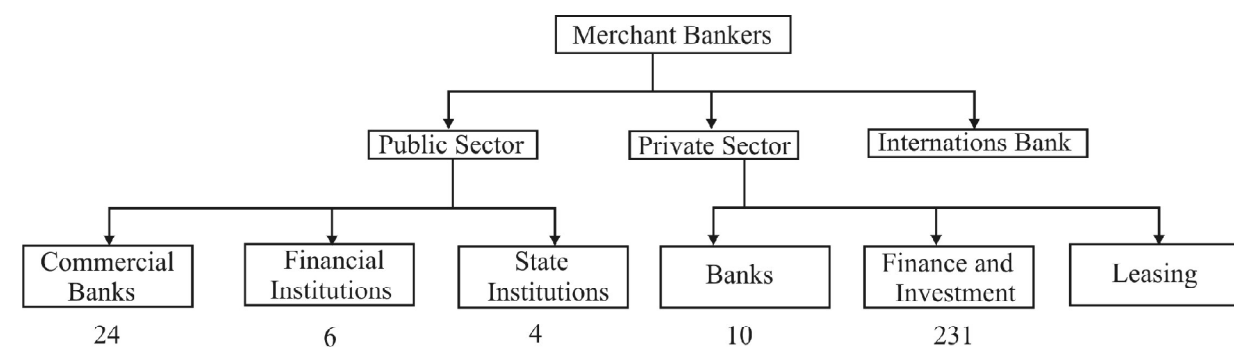
- The concept was developed in London. When the merchants started floating bonds in London Money Markets to aid government of underdeveloped countries. The funds were raised for the long-term needs of the developing economies.
- Later, merchants moved to domestic business

through syndication of short-term and long-term finance. With time, the scope of merchant bankers extended to underwriting of new issues, serving as registrars and share transfer agents, debenture trustees, portfolio managers etc.

- They also undertook specific functions like negotiating agents for mergers and takeover.
- The growing concept of merchant banking gained prominence in America and other countries also.
- Euro dollar and other innovative instruments were introduced and new financial centers were established in Singapore, Hong Kong, Dubai etc.

Merchant Banking in India

- Specialized merchant banking services originated in India in 1969, when the ANZ Grindlays bank set-up the merchant banking division.
- It started with the management of public issues and selected consultancy services for corporate enterprises.
- Foreign banks like National Grindlays Bank and the City Bank felt the need for the merchant banking services due to the rapid growth of the issues in primary market. In 1972, the institution to set-up merchant banking institutions, Eventually SB1 become the first Indian commercial bank to following year, ICICI was the first financial institution to offer Merchant Banking services have set-up Merchant Banking division in 1972.
- Thus, the early seventies mark the growth of merchant banking in India. At the outset, commercial banks, broker firms and financial institutions were offering merchant banking services in addition to the traditional services.
- In the mid-eighties, amendments in Banking Regulation Act, were made to encourage commercial banks to offer wider variety of financial services through their subsidiaries.
- By late eighties 33 merchant banks were operating including. Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO Bank. Initially these players dealt with new capital issues management only.
- In 1992, reforms were made in the capital markets and Indian economy was deregulated.
- SEBI was conferred statutory powers, Capital Issues Control Act was enacted and office of the controller of Capital Issues was abolished.
- All these reforms contributed to the improvement in efficiency and regulation of capital markets resulting in greater need for merchant banking. Merchant bankers assumed greater responsibility towards the investors in both legal and moral aspects.
- Considering the growing needs of the markets, nationalized banks opened up subsidiaries companies to operate as merchant banks.
- By the end of 1992, there were 115 merchant banks.
- The number increased to 501 in just two years (some merchant banks collaborated to expand their services to overseas). Besides, we now have global merchant bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming etc.



5.1.2 Services of Merchant Banks

Q3. Explain the various Services of Merchant Bankers.

(or)

Explain the scope of merchant banking.

Ans :

Functions (Services) of Merchant Bankers (Scope of Merchant Banking)

Merchant banks have been playing an important role in procuring the funds for capital market for the corporate sector for financing their operations. They perform some valuable functions.

The functions of merchant banks in India are as follows:

1. Corporate counseling

One of the important functions of a merchant banker is corporate counseling. Corporate counseling refers to a set of activities undertaken to ensure efficient functioning of a corporate enterprise through effective financial management. A merchant banker guides the client on aspects of organizational goals, vocational factors, organization size, choice of product, demand forecasting, cost analysis, allocation of resources, investment decisions, capital and expenditure management, marketing strategy, pricing methods etc.

The following activities are included in corporate counseling:

- Providing guidance in areas of diversification based on the Government's economic and licensing policies.
- Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.
- Rejuvenating old-line companies and ailing sick units by appraising their technology and process, assessing their requirements and restructuring their capital base.
- Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.
- Arranging for the approval of the financial institutions/banks for schemes of rehabilitation involving financial relief, etc.
- Monitoring of rehabilitation schemes.
- Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

2. Project counseling

Project counseling relates to project finance. This involves the study of the project, offering advisory services on the viability and procedural steps for its implementation.

Project counseling involves the following activities:

- (a) Undertaking the general review of the project ideas/project profile.
- (b) Providing advice on procedural aspects of project implementation.
- (c) Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.
- (d) Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consents for implementation of the project.
- (e) Assisting in obtaining approvals/licenses/permissions/grants, etc from government agencies in the form of letter of intent, industrial license, DGTD registration, and government approval for foreign collaboration.
- (f) Identification of potential investment avenues.
- (g) Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.
- (h) Undertaking financial study of the project and preparation of viability reports to advise on the framework of institutional guidelines and laws governing corporate finance.
- (i) Providing assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas, covering the technical, financial and economic aspects of the project from the point of view of their acceptance by financial institutions and banks.

- (j) Advising and assisting clients in preparing applications for financial assistance to various national financial institutions, state level institutions, banks, etc.

3. Pre-investment studies

Another function of a merchant banker is to guide the entrepreneurs in conducting pre-investment studies. It involves detailed feasibility study to evaluate investment avenues to enable to decide whether to invest (or) not.

The important activities involved in preinvestment studies are as follows:

- (a) Carrying out an in-depth investigation of environment and regulatory factors, location of raw material supplies, demand projections and financial requirements in order to assess the financial and economic viability of a given project.
- (b) Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to promote corporate profitability and growth in the long run.
- (c) Offering a package of services, including advice on the extent of participation, government regulatory factors and an environmental scan of certain industries in India.

4. Loan syndication

A merchant banker may help to get term loans from banks and financial institutions for projects. Such loans may be obtained from a single financial institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from commercial banks.

The following activities are undertaken by merchant bankers under loan syndication:

- (a) Estimating the total cost of the project to be undertaken.
- (b) Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.

- (c) Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.
- (d) Selecting institutions and banks for participation in financing.
- (e) Follow-up of term loan application with the financial institutions and banks, and obtaining the approval for their respective share of participation.
- (f) Arranging bridge finance.
- (g) Assisting in completion of formalities for drawing of term finance sanctioned by institutions by expediting legal documentation formalities, drawing up agreements etc. as prescribed by the participating financial institutions and banks.
- (h) Assessing working capital requirements.

5. Issue management

Issue management involves marketing or corporate securities by offering them to the public. The corporate securities include equity shares, preference shares, bonds, debentures etc. Merchant bankers act as financial intermediaries. They transfer capital from those who own it to those who need it. The security issue function may be broadly classified into two—pre-issue management and post-issue management. The pre-issue management involves the following functions:

- (a) Public issue through prospectus.
- (b) Marketing and underwriting.
- (c) Pricing of issues.

These may be briefly discussed as follows:

- (a) **Public issue through prospectus:** To bring out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. First the prospectus should be drafted.

The copies of consent of experts, legal advisor, attorney, solicitor, bankers, and bankers to the issue, brokers and underwriters are to be obtained from the company making the issue. These copies are to be filed along with the prospectus to the Registrar Companies. After the prospectus is ready, it has to be sent to the SEBI for clearance. It is only after clearance by SEBI, the prospectus can be filed with the Registrar. The brokers to the issue, principal agent and bankers to issue are appointed by merchant bankers.

- (b) **Marketing and underwriting:** After sending prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaigns and fixing date of board meeting to approve and pass the necessary resolutions.

The role of merchant banker in publicity campaigns to help selecting the media, determining the size and publications in which the advertisement should appear. The merchant bank shall decide the number of copies to be printed, check accuracy of statements made and ensure that the size of the application form and prospectus are as per stock exchange regulations. The merchant banker has to ensure that the material is delivered to the stock exchange at least 21 days before the issue opens and to the brokers to the issue, and underwriters in time.

- (c) **Pricing of issues :** Pricing of issues is done by companies themselves in consultation with the merchant bankers. An existing listed company and a new company set up by an existing company with 5 year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with 2 ½

years track record of constant profitability can freely price the issue. The premium can be determined after taking into consideration net asset value, profit earning capacity and market price. The price and premium has to be stated in the prospectus.

Post-issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedures, mailing of allotment letters, share certificates and refund orders. Merchant bankers help the company by co-ordinating the above activities.

6. Underwriting of public issue

In underwriting of public issue the activities performed by merchant bankers are as follows:

- (a) Selection of institutional and broker underwriters for syndicating/ underwriting arrangements.
- (b) Obtaining the approval of institutional underwriters and stock exchanges for publication of the prospectus.
- (c) Co-ordination with the underwriters, brokers and bankers to the issue, and the Stock Exchanges.

7. Portfolio management

Merchant bankers provide portfolio management service to their clients. Today every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. Merchant bankers help the investors in this regard. They study the monetary and fiscal policies of the government. They study the financial statements of companies in which the investments have to be made by investors. They also keep a close watch on the price movements in the stock market.

The merchant bankers render the following services in connection with portfolio management:

- (a) Undertaking investment in securities.
- (b) Collection of return on investment and re-investment of the same in profitable avenues, investment advisory services to the investors and other related services.
- (c) Providing advice on selection of investments.
- (d) Carrying out a critical evaluation of investment portfolio.
- (e) Securing approval from RBI for the purchase/sale of securities (for NRI clients).
- (f) Collecting and remitting interest and dividend on investment.
- (g) Providing tax counseling and filing tax returns through tax consultants.

8. Merger and acquisition

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over refers to the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

9. Foreign currency financing

The finance provided to fund foreign trade transactions is called 'Foreign Currency Finance'. The provision of foreign currency finance takes the form of exportimport trade finance, euro currency loans, Indian joint ventures abroad and foreign collaborations.

The main areas that are covered in this type of merchant activity are as follows:

- (a) Providing assistance for carrying out the study of turnkey and construction contract projects.
- (b) Arranging for the syndication of various types of guarantees, letters of credit, pre-shipment credit, deferred post-shipment credit, bridge loans, and other credit facilities.
- (c) Providing assistance in opening and operating bank accounts abroad.
- (d) Arranging foreign currency loans under buyer's credit scheme for importing goods.
- (e) Arranging deferred payment guarantees under suppliers credit scheme for importing capital goods.
- (f) Providing assistance in obtaining export credit facilities from the EXIM bank for export of capital goods, and arranging for the necessary government approvals and clearance.
- (g) Undertaking negotiations for deferred payment, export finance, buyers credits, documentary credits, and other foreign exchange services like packing credit, etc.

10. Working capital finance

The finance required for meeting the day-to-day expenses of an enterprise is known as 'Working Capital Finance'. Merchant bankers undertake the following activities as part of providing this type of finance:

- (a) Assessment of working capital requirements.
- (b) Preparing the necessary application to negotiations for the sanction of appropriate credit facilities.

11. Acceptance credit and bill discounting

Merchant banks accept and discount bills of exchange on behalf of clients. Merchant bankers give loans to business enterprises on the security of bill of exchange. For this purpose, merchant bankers collect credit information relating to the clients and undertake rating their creditworthiness.

12. Venture financing

Another function of a merchant banker is to provide venture finance to projects. It refers to provision of equity finance for funding high-risk and high-reward projects.

13. Lease financing

Leasing is another function of merchant bankers. It refers to providing financial facilities to companies that undertake leasing. Leasing involves letting out assets on lease for a particular period for use by the lessee. The following services are provided by merchant bankers in connection with lease finance:

- (a) Providing advice on the viability of leasing as an alternative source for financing capital investment projects.
- (b) Providing advice on the choice of a favourable rental structure.
- (c) Providing assistance in establishing lines of lease for acquiring capital equipment, including preparation of proposals, documentations, etc.

14. Relief to sick industries

Merchant bankers render valuable services as a part of providing relief to sick industries.

15. Project appraisal

Project appraisal refers to evaluation of projects from various angles such as technology, input, location, production, marketing etc. It involves financial appraisal, marketing appraisal, technical appraisal, economic appraisal etc. Merchant bankers render valuable services in the above areas.

The functions of merchant banker can be summarized as follows:

- (a) Issue management.
- (b) Underwriting of issues.
- (c) Project appraisal.
- (d) Handling stock exchange business on behalf of clients.
- (e) Dealing in foreign exchange.
- (f) Floatation of commercial paper.

- (g) Acting as trustees.
- (h) Share registration.
- (i) Helping in financial engineering activities of the firm.
- (j) Undertaking cost audit.
- (k) Providing venture capital.
- (l) Arranging bridge finance.
- (m) Advising business customers (i.e. mergers and takeovers).
- (n) Undertaking management of NRI investments.
- (o) Large scale term lending to corporate borrowers.
- (p) Providing corporate counseling and advisory services.
- (q) Managing investments on behalf of clients.
- (r) Acting as a stock broker.

Q4. What are the objectives of merchant banking ?

Ans :

The objectives of merchant banking are as follows:

1. To help for capital formation.
2. To create a secondary market in order to boost the industrial activities in the country.
3. To assist and promote economic endeavour.
4. To prepare project reports, conduct market research and pre-investment surveys.
5. To provide financial assistance to venture capital.
6. To build a data bank as human resources.
7. To provide housing finance.
8. To provide seed capital to new enterprises.
9. To involve in issue management.
10. To act as underwriters.
11. To identify new projects and render services for getting clearance from government.

12. To provide financial clearance.
13. To help in mobilizing funds from public.
14. To divert the savings of the country towards productive channel.
15. To conduct investors conferences.
16. To obtain consent of stock exchange for listing.
17. To obtain the daily report of application money collected at various branches of banks.
18. To appoint bankers, brokers, underwrites etc.
19. To supervise the process on behalf of NRIs for their ventures.
20. To provide service on fund based activities.
21. To assist in arrangement of loan syndication.
22. To act as an acceptance house.
23. To assist in and arrange mergers and acquisitions.

5.1.3 Problems of merchant banks

Q5. Explain the problems of merchant banks in India.

Ans :

1. SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management. It restricts the scope of merchant bank activities.
2. SEBI guidelines stipulate a minimum net worth of Rs.1 crore for authorisation of merchant bankers. Small but professional merchant bankers are facing difficulty for adhering such net worth norms.
3. Non cooperation of the issuing companies in timely allotment of securities and refund application money is another problem of merchant bankers.
4. Unhealthy competition among large number of merchant banks compels them to reduce their profit margin, commission etc.
5. There is no exact regulatory framework for regulating and controlling the working of merchant banks in India.

6. Fraudulent and fake issue of share capital by the companies are also posing problems for merchant banks who act as lead manager or issue manager of such issues.

5.1.4 Scope of Merchant Banking in India

Q6. The scope for merchant banking is great in India. Discuss

Ans :

In the present day capital market scenario, the merchant banks play the role of an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

1. Growth of New Issues Market

The growth of new issue market is unprecedented since 1990-91. The amount of annual average of capital issues by non-government public companies was only about 90 crores in the 70s, the same rose to over Rs. 1,000 crs in the 80s' and further to Rs. 12,700 crores in the first four years of 1990's. This figure could be well beyond Rs. 40,000 crores by the end of 1994-95. The number of capital issues has also increased from 363 in 1990-91 to 900 in 1993-94. The trend is expected to continue in future.

2. Entry of Foreign Investors

An outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly tap foreign capital through euro issues.

Within two years to March 1994, the total inflow of foreign capital through these routes reached to about \$5 billion. It is estimated that this figure may go up to \$ 35-40 billion by the turn of this century. Further, foreign direct investment as also investment by NRIs have risen considerably due to number of incentives offered to them. They need the

services of Merchant Bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also require expert services of Merchant Bankers.

3. Changing Policy of Financial Institutions

With the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would require the expert services of merchant bankers for project appraisal, financial management etc.

The policy of decentralisation and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by merchant bankers.

4. Development of Debt Market

The concept of debt market has set to work through National Stock Exchange and the Over the Counter Exchange of India. Experts feel that of the estimated capital issues of Rs. 40,000 crores in 1994-95, a good portion may be raised through debt instruments. The development of debt market will offer tremendous opportunity to Merchant Bankers.

5. Innovations in Financial Instruments

The Indian capital market has witnessed innovations in the introduction of financial instruments such as non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, secured premium notes, floating rate bonds, auction rated debentures etc. This has further extended the role of Merchant Bankers as market makers for these instruments.

6. Corporate Restructuring

As a result of liberalisation and globalisation the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning. This had led to corporate restructuring including

mergers, acquisitions, splits, disinvestments and financial restructuring. This offers good opportunity to Merchant Bankers to extend the area of their operations.

7. Disinvestment

The government raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 1993-94. The government proposes to shift the present method of periodic sale of public sector shares to round the year off loading of shares directly on the stock exchange from the year 1995-96.

The government will sell the shares of identified public sector at any time during the year when they get a good price above minimum stipulated level. This is likely to provide good business to Merchant Bankers in future.

The above discussion highlights, that the scope of merchant banking is vast and there lies immense opportunities ahead of Merchant Bankers. They should develop adequate infrastructure including expertise in order to provide full range of merchant banking services to corporate sector.

Q7. Compare and contrast merchant banks and commercial bank.

Ans :

Merchant banks are different from commercial banks. The following are the important differences between merchant banks and commercial banks:

1. Commercial banks basically deal in debt and debt related finance. Their activities are clustered around credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant bankers is equity and equity related finance. They deal with mainly funds raised through money market and capital market.
2. Commercial banks' lending decisions are based on detailed credit analysis of loan proposals and the value of security offered. They generally avoid risks. They are asset

oriented. But merchant bankers are management oriented. They are willing to accept risks of business.

3. Commercial banks are merely financiers. They do not undertake project counselling, corporate counselling, managing public issues, underwriting public issues, advising on portfolio management etc. The main activity of merchant bankers is to render financial services for their clients. They undertake project counselling, corporate counselling in areas of capital restructuring, mergers, takeovers etc., discounting and rediscounting of short-term paper in money markets, managing and underwriting public issues in new issue market and acting as brokers and advisors on portfolio management.

Q8. Explain the principal qualities of successful merchant banker.

Ans :

Merchant bankers has a prominent role to play in transforming conceptual idea into industrial ventures. They are helpful in prior incorporation of activities like market surveys, location, its capacity, documents preparation and approval from various authorities.

Merchant bankers are useful in decision making in managing finance, public issues, credit syndication etc.

Thus, quality of their service and substantial advises to clients are the criteria for success of merchant bankers.

The following are the principal qualities of successful merchant banker.

(i) Analytical Ability

Basic quality that a merchant banker must possess is analyzing not only financial and economic features but also technical details, which are in relation to business project.

(ii) Awareness

Merchant banker must be aware about the recent changes of capital markets, stock exchange, public investments, economic and technological fluctuations within the country.

iii) Capacity

Merchant bankers must have the capacity to develop bank-client relationship, so that projects can be carried-out with great involvement.

iv) Innovation

In development of capital market instruments and public investments,, merchant bankers must possess innovative techniques.

v) Integration

Merchant bankers must integrate professional standards and must be able to maintain high standards with clients.

5.2 VENTURE CAPITAL**5.2.1 Meaning of venture capital****Q9. Define the term Venture Capital.**

Ans :

Introduction

There are some businesses that involve higher risks. In the case of newly started business, the risk is more. The new businesses may be promoted by qualified entrepreneurs. They lack necessary experience and funds to give shape to their ideas. Such high risk, high return ventures are unable to raise funds from regular channels like banks and capital markets.

Generally people would not like to invest in new high risk companies. Some people invest money in such new high risk companies. Even though the risk is high, there is a potential of getting a return of ten times more in less than five years. The investors making such investments are called venture capitalists.

The money invested in new, high risk and high return firms is called venture capital. Venture capitalists not only provide money but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. They get good return on their investment. The percentage of the profits the venture capitalists get is called the carry.

Meaning of Venture Capital

The term venture capital comprises of two words, namely, 'venture' and 'capital'. The term

'venture' literally means a 'course' or 'proceeding', the outcome of which is uncertain (i.e., involving risk). The term capital refers to the resources to start the enterprise. Thus venture capital refers to capital investment in a new and risky business enterprise. Money is invested in such enterprises because these have high growth potential.

A young hi-tech company that is in the early stage of financing and is not yet ready to make a public issue may seek venture capital. Such a high risk capital is provided by venture capital funds in the form of long term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Venture capital is the money and resources made available to start up firms and small business with exceptional growth potential (e.g., IT, infrastructure, real estate etc.). It is fundamentally a long term risk capital in the form of equity finance for the small new ventures which involve risk. But at the same time, it has the strong potential for the growth. It thrives on the concept of high risk high return. It is a means of equity financing for rapidly growing private companies.

Venture capital can be visualized as 'your ideas and our money' concept of developing business. It is 'patient' capital that seeks a return through long term capital gain rather than immediate and regular interest payments as in the case of debt financing.

When venture capitalists invest in a business, they typically require a seat on the company's board of directors. But professional venture capitalists act as mentors and provide support and advice on a number of issues relating to management, sales, technology etc. They assist the company to develop its full potential. They help the enterprise in the early stage until it reaches the stage of profitability. When the business starts making considerable profits and the market value of the shares go up to considerable extent, venture capitalists sell their equity holdings at a high value and thereby make capital gains.

In short, venture capital means the financial investment in a highly risk project with the objective of earning a high rate of return.

Definition

“A financial institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprises”

5.2.2 Features of venture capital

Q10. Explain the features of venture capital.

Ans :

Features of Venture Capital

Some of the features of venture capital financing are as under :

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.
3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.
5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.
7. Venture capital is not just injection of money but also an input needed to set-up the firm, design its marketing strategy and organise and manage it.
8. Investment is usually made in small and medium scale enterprises.

5.2.3 Scope of venture capital

Q11. Discuss the scope of venture capital in India.

Ans :

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation.

The various stages in the financing of venture capital are described below:

1. Development of an Idea — Seed Finance

In the initial stage venture capitalists provide seed capital for translating an idea into business proposition. At this stage investigation is made indepth which normally takes a year or more.

2. Implementation Stage — Start up Finance

When the firm is set up to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

3. Fledging Stage — Additional Fiance

In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

4. Establishment Stage — Establishment Finance

At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of the establishment

stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exit routes.

Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems.

After assessing the viability of projects, the investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation.

All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks invest in one or more. Hence they specialize in one or more but rarely all.

5.2.4 Importance of venture capital

Q12. Discuss the importance of venture capital in India.

Ans :

Venture capital is of great practical value to every corporate enterprise in modern times.

(A) Advantages to investing Public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.
2. Investors or have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyse the prospects of the business.
3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

(B) Advantages to Promoters

1. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.
2. Public issue of equity shares has to be preceded by a lot of efforts viz. necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.
3. Costs of public issues of equity share often range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs, for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

(C) General

1. A developed venture capital institutional set-up reduces the time lag between a technological innovation and its commercial exploitation.
2. It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.
3. Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with inadequate margin of equity capital.
4. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the

form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.

5. The economy with well developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilising industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.
6. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.
7. It also paves the way for private sector to share the responsibility with public sector.

Q13. Explain the structuring of venture capital institutions of India.

Ans :

Venture capital business is growing at a faster pace in the Indian financing segment. Several Indian financial institution have made endeavours to develop and promote venture capital financing. The venture capital institution's structure, its legal and tax implications are significant for the profitability of the organizations and their participants. The VCI's are structured as follows,

1. An investment company
2. A unit trust
3. As a scheme of the United Trust of India and
4. As a division of a financial institution or a bank.

1. Investment Company Form of Structure

The investment company form of structure is designed on the usual pattern of company form

and the liability of the shareholders is limited. They are subjected to tax benefits under CCI guidelines 1988 on long term capital gains but the shareholder's income is fully taxable.

They are also subjected to CBDT guidelines 1995 regarding the dividend income. Examples are the Lazard Credit Capital Venture Finance Corporation Ltd. and ILFS Venture Capital Company Ltd.

2. Unit Trust Form of Structure

The unit trust form of structure is established under the Indian Trust Act. The individuals/corporate bodies contributes capital and is managed by asset management company. Unit trust is subjected to a management fee and interest. Example is, the Indus Venture Fund.

3. As a Scheme of UTI

The venture capital funds are constituted as Venture Capital Unit Schemes (VECAUSs), which are subscribed to the other institutions in collaboration/partnership. UTI sponsors two institutions namely TDICI Ltd. and RCTC Ltd. The VECAUSs are subjected to the same tax benefits as that of UTI.

4. Division of a Financial Institution (FI)/ Bank

The venture capital fund is established as a division but not as an independent legal entity. Examples are IDBI Venture Capital Fund Scheme (IDBI-VCFS), Canara Bank Venture Capital Fund (CVCF), India Investment Fund of Grindlays Bank.

Regulatory Framework

Securities and Exchanges Board of India (SEBI) regulates the working of Venture Capital Funds in India. The main provisions of the Securities and Exchanges Board of India (SEBI) guidelines are as follows.

- (a) A Venture Capital Fund (VCF) is not permitted to invest in the equity shares of any company providing financial services.
- (b) The money raised by venture capital fund from any investor should not be less than five lakh rupees.

- (c) The Venture Capital Funds (VCF) shall not issue any advertisement inviting offers from the public for subscription of its securities.
- (d) A venture capital fund may be setup only after a certificate of registration is granted by Securities and Exchanges Board of India (SEBI).
- (e) The venture capital fund is bound by the provisions of Securities and Exchanges Board of India (SEBI) Act and the guidelines framed under it.
- (f) The Venture Capital Funds (VCF) should not carryout any activity other than that of a venture capital fund.
- (g) At least 80% of the funds raised by a Venture Capital Funds (VCF) shall be invested in equity of a company.
- (h) The securities or units issued by a venture capital fund shall not be listed on any recognized stock exchange till the expiry of 4 years from the date of issuance of such securities.
- (i) A scheme of Venture Capital Funds (VCF) set up as a trust shall be wound up when the period of the scheme is over.

14. Discuss about various methods of VCF evaluation.

Ans :

Venture capital investments are mostly idea-based and growth-based unlike the conventional investments which were asset-based investments. The conventional investments were evaluated on the basis of tangible assets/ future earnings streams where as the venture capital investments are evaluated on the basis of nature of things evaluated differently in order to decide the required venture capital percentage ownership of the VCs in venture capital undertaking. The following are the evaluation methods,

1. Conventional venture capitalist valuation method
2. The first Chicago method
3. Revenue multiplier method.

1. Conventional Venture Capitalist Valuation Method

Conventional venture capitalist valuation method of Venture Capital Undertakings (VCUs) or investee companies considers two important factors in venture capital investments life-time first one the starting time of investment and second one. the exit time of investment wherein the investment would be converted into cash via sale to third party. The following steps are followed in valuation of venture capital undertakings and determination of the percentage share ownership of the venture capital institution and investee companies,

- (a) Firstly the annual revenue at the time of liquidation is calculated. In order to calculate the annual revenue, the present annual income/revenue in the starting is compounded by an expected annual growth rate for the specific holding period say, seven years.
- (b) Secondly the expected earnings level is computed by multiplying the future earnings level with after tax margin percentage at the time of liquidation.
- (c) Thirdly compute the future market valuation of the venture capital undertaking by multiplying the earnings level with expected P/E ratio on the liquidation date.
- (d) Calculate the net present value of the venture capital undertaking using a suitable discounting factor.
- (e) If the present value is say, for example Rs.1 crore and the entrepreneur needs only Rs. 40 lakhs as the venture capital then the minimum percentage of ownership is two-fifth i.e., 40 percent.

The drawback of conventional venture capitalist valuation method is that it does not take into consideration the existence of earnings or the earnings stream during the entire period and gives more importance to the exit date.

2. The First Chicago Method

The first Chicago method is a better one and an improved one when compared to the conventional method of valuation because it allows nature and path between the starting point and the

exit point and also consider the complete earning's stream.

This method includes the following steps:

- (i) Three alternatives namely, 'success', 'sideways survival' and 'failure' are considered. All the three alternatives are assigned with certain probability rate.
- (ii) Calculate the discounted present value of the venture capital undertaking by using a discounted rate. Usually, the discounted rate is higher than the risk rate.
- (iii) Multiply the discounted present value with the respective probabilities. The resultant of the sum of the three alternatives is equal to the expected present value.
- (iv) If the expected present value of the VCU is Rs. 10 A. crore and the fund required from the VCIs is Rs. 5 crore, then the minimum ownership required is 50 percent.

3. Revenue Multiplier Method

A revenue multiplier method is a factor that can be used to estimate the value of a venture capital undertaking. By multiplying that factor the annual revenue of the company is calculated or assessed by the VCIs. Symbolically, it can be represented as follows,

$$M_t = \frac{V}{R} = \frac{(1+r)^n (a)(p)}{(1+d)^n}$$

Where,

V = Present value of the VCU.

R = Annual revenue level.

r = Expected annual rate of growth of revenue.

n = Expected number of years from the starting date to the exit date (holding period).

a = Expected after-tax profit margin percentage at the time of exit.

p = Expected price/earnings (P/E) ratio at exit time.

d = Appropriate discount note for a venture investment at this stage, risk and other relevant factors.

The revenue multiplier method is usually used in the early stage/start-up venture capital investments when the earnings, based on after-tax profits, may be low/ negative in the starting years but the income/sales revenue would exist. This method needs data which may or may not be present in India which is in its developing stage at this level of VCFs growth. In cases, where it is not possible or difficult to use revenue multiplier method, the first Chicago method yields good and better results than the conventional valuation method.

5.3 LEASING

5.3.1 Definition

Q15. Define the term leasing.

Ans :

Meaning of leasing

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.
2. The document in which this contract is written.
3. A great way companies can conserve capital.
4. An easy way vendors can increase sales.

Definitions

According to Dictionary of Business and Management

According to James C. Van Horne 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'

'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the

exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'

According to Equipment Leasing Association of UK 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental.

In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

Q16. What are the characteristics of leasing?

Ans :

The following are the characteristics of a lease:

1. The Parties

Lease agreement involves two parties i.e., the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for periodical rental payment for an agreed period (pre-determined) of time.

2. The Asset

Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery, building, and so on. In leasing the ownership

of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lessor where as it use is being transferred to the lesser.

3. The Term

The term of lease agreement is known as lease period. It considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Quite a few times the lease period is being divided into primary lease period and secondary lease period.

4. The Lease Rentals

Lease rentals forms the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up such cost i.e., interest on the lessor's investment, any repairs and maintenance costs which forms the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease.

Q17. What are the advantages and disadvantages of leasing.

Ans :

Advantages of Leasing

The following are the advantages of leasing :

1. Permit Alternative Use of Funds

A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

2. Faster and Cheaper Credit

Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going thorough formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

3. Flexibility

Leasing arrangements may be tailored to the lessee's needs more easily than ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to be low.

4. Facilitates Additional Borrowings

Leasing may increase long-term ability to acquire funds. The lessee can utilise more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arises.

5. Protection against obsolescence

A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

6. No Restrictive Covenants

The restrictive covenants such as debt equity ratio, declaration of dividend etc., which are usually imposed under debenture or loan agreement are absolutely absent in a lease agreement.

7. Hundred Percent Financing

Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So hundred percent financing is assured to the lessee.

8. Boon to Small Firm

The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial institutions.

Disadvantages of Leasing

1. Lease is not suitable mode of project finance. This is because rentals are repayable soon after entering into lease agreement while in new projects cash generations may start only after a long gestation period.

2. Certain tax benefits/incentives such as subsidy may not be available on leased equipment.
3. The value of real assets such as land and building may increase during lease period. In such a case the lessee loses the advantage of a potential capital gain.
4. The cost of financing is generally higher than that of debt financing.
5. A manufacturer who wants to discontinue a particular line of business will not be in a position to terminate the contract except by paying heavy penalties. If it is a owned asset the manufacturer can sell the equipment at his will.
6. If the lessee is not able to pay rentals regularly, the lessor would suffer a loss particularly when the asset is a sophisticated one and less liquid.
7. In case of lease agreement, it is lessor who has purchased the asset from the supplier and not the lessee. Hence, the lessee by himself is not entitled to any protection in case the supplier commits breach of warranties in respect of the leased assets.
8. In the absence of exclusive laws dealing with the lease transaction, several problems crop up between lessor and lessee resulting in unnecessary complications and avoidable tensions

5.3.2 Steps Involved in Leasing**Q18. Outline the steps involved in leasing transactions.**

Ans :

The steps involved in a leasing transaction are summarised as follows:

1. First, the lessee has to decide the asset required and select the supplier. He has to decide about the design specifications, the price, warranties, terms of delivery, servicing etc.
2. The lessee, then enters into a lease agreement with the lessor. The lease agreement contains the terms and conditions of the lease such as,
 - (a) The basic lease period during which the lease is irrecoverable.

- (b) The timing and amount of periodical rental payments during the lease period.
 - (c) Details of any option to renew the lease or to purchase the asset at the end of the period.
 - (d) Details regarding payment of cost of maintenance and repairs, taxes, insurance and other expenses.
3. After the lease agreement is signed the lessor contacts the manufacturer and requests him to supply the asset to the lessee. The lessor makes payment to the manufacturer after the asset has been delivered and accepted by the lessee.

5.4 TYPES OF LEASE

5.4.1 Financial Lease

Q19. Define the term financial lease.

Ans :

A financial lease is also known as Capital lease, Long-term lease, Net Lease and Close lease.

- In a financial lease, the lessee selects the equipments, settles the price and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable and non-cancellable contractual agreement with the leasing company.
- The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it.
- He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.
- The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain a non cancellable clause which means that the lessor transfers the title to the lessee at the end of the lease period.

- Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available.
- The leasing company also charges nominal service charges to cover legal and other costs.
- The leasing company may also insist on collaterals or bank's guarantee in individual cases.
- In a large number of cases, the financial leases are used as financing cum tax planning tool.
- The financial lease is very popular in India as in other countries like USA, UK and Japan.
- On an all India basis, at present, approximately a lease worth Rs. 75 to Rs. 100 crores is transacted as a tax planning device.
- The high cost of equipments such as office equipment, diesel generators, machine tools, textile machinery, containers, locomotives etc., are leased under financial lease.

5.4.2 Operating Lease

Q20. Explain briefly about operating lease.

Ans :

An operating lease is also known as Service lease, Short term lease or True lease.

- In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment.
- This means that the lease is for a limited period, may be a month, six months, a year or few years.
- The lease is terminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. The risk of obsolescence is enforced on the lessor who will also bear the cost of maintenance and other relevant expenditure.

- The lessor also does the services like handling warranty claims, paying taxes, scheduling and performing maintenance and keeping complete records lease is suitable for,
- (i) Computers, copy machines and other office equipments, vehicles, material handling equipments etc. Which are sensitive to obsolescence and
- (ii) Where the lessee is interested in tiding over temporary problem.

Q21. Distinguish between financial lease and operating lease.

Ans :

S.No.	Financial Lease	Operating Lease
1.	A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment.	1. An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period.
2.	It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2. Operating lease provides for maintenance expenses and taxes of the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3. Leasing company assumes risk of obsolescence.
4.	Contract period ranges from medium to long term.	4. Contract period ranges from intermediate to short-term.
5.	Contracts are usually non cancellable.	5. Contracts are usually cancellable either by the lessor or by the lessee.
6.	Air crafts, land and building heavy machinery are leased.	6. Computers, office equipments, automobiles, truck etc. are leased.
7.	The lease involves a financial commitment similar to a loan by a leasing company. It places the lessee in a position of borrow.	7. The financial commitment is restricted to regular rental payment. The rentals find a place in the P & LA/c of the lessee.
8.	The lessor fulfills financial function.	8. The lessor fulfills service function.

5.4.3 Leverage Lease

Q22. Define the term leverage lease.

Ans :

A leverage lease is used for financing those assets which require huge capital outlay.

- The outlay for purchase cost of the asset generally varies from Rs. 50 lakhs to Rs. 2 crore and has economic life of 10 years or more.
- The leverage lease agreement involves three parties, the lessee, the lessor and the lender.
- The lessor acquires the assets as per the terms of the lease agreement but finances only a part of the total investment, say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor.
- The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments.
- The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease.
- In leveraged lease, a wide range of equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc. are acquired.

- Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment.
- By investing 20% or 25% of the cost of an asset, the lessor is entitled to 100% allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible.
- From the point of view of lessee, lease rentals are deductible in full as an operating expense.

5.4.4 Sale and Lease Back

Q23. Explain briefly about Sale and Lease Back.

Ans :

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease.

- The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the lease period.
- The firm makes periodical rental payment to the lessor.
- The title to the asset vests with the lessor. Most of the lease back agreements are on a net basis which means that the lessee pays all maintenance expenses, property taxes and insurance.
- In some cases, the lease agreement allows the lease to repurchase the property at the termination of lease.
- The sale and lease back agreement is beneficial to both lessor and lessee.
- The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits.
- Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

Q24. Explain the other types of leasing in India.

Ans :

1) First Amendment Lease

The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.

2) Full Payout Lease

A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

3) Guideline Lease

A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

4) Net Lease

A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.

5) Open-end Lease

A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

6) Sales-type Lease

A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

7) Synthetic Lease

A synthetic lease is basically a financing structured to be treated as a lease for

accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

8) Tax Lease

A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition of this tax incentive.

9) True Lease

A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

Q25. Enumerate the various problems of leasing in India.

Ans :

Leasing has great potential in India. However, leasing in India faces serious handicaps which may bar its growth in future. The following are some of the problems.

1. Unhealthy competition

There is over supply of lessor in India. The stiff competition between these lessors forces them to reduce their profit margin to bare minimum level. Moreover, subsidiaries of banks and financial institutions have a competitive edge over private sector lessors due to their cheap source of finance.

2. Lack of qualified personnel

Leasing requires qualified and experienced personnel at the helm of its affairs. In India, leasing is of recent origin and hence it is difficult to get the right man to deal with leasing business.

3. Tax Consideration

In reality, the lessee's tax shelter is the lessor's burden. The lease becomes economically viable if the lessor's effective tax rate is low. Moreover, over taxes like sales tax, wealth tax, additional

tax, surcharge etc., add to the cost of leasing. It makes leasing relatively more expensive.

4. Stamp Duty

States treat the leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as pure lease transactions. Accordingly, heavy stamp duty is imposed on lease documents.

5. Delayed payment and bad debts

The problem of delayed payment of rents and bad debts adds to the cost of lease. This problem would disturb prospects of leasing business.

5.5 DISCOUNTING

5.5.1 Concept of discounting

Q26. Define the term discounting.

Ans :

Generally, a trade bill arises out of a genuine credit trade transaction.

- The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit.
- It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date.
- In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold.
- It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process.
- It is where the commercial banks enter into as a financier.
- The commercial banks provide immediate cash by discounting genuine trade bills.
- They deduct a certain charge as discount charges from the amount of the bill and the

balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills.

- Ofcourse, this discount charges include interest for the unexpired period of the bill plus some service charges.
- Bill financing is the most liquid one from the banker's point of view since, in time of emergencies, they can take those bills to the Reserve Bank of India for rediscounting purposes.
- Infact, it was viewed primarily as a scheme of accommodation for banks. Now, the situation is completely changed. To-day it is viewed as a kind of loan backed by the security of bills.

Q27. What is bill discounting ? Explain the characteristics of bill discounting.

Ans :

Bill discounting is a process where in a seller deposits actual commercial bills and receives financial accommodation from a bank (or) financial institution.

Characteristics

The characteristics of bill discounting area as follows:

1. Discount Charge

Discount is the margin between the advance which is provided by the bank and the face value of the bill. It is computed on the maturity value at a rate of specify percentage per annum.

2. Maturity

The date on which the payment will fall due is known as maturity date. The normal maturity periods are 30, 60, 90 or 120 days. But the bills maturity within 90 days are more common.

3. Ready Finance

In order to assists the customers in receiving immediate finance from the bank, the banks discount and purchase the bills of their customers. The customers does not have to wait till the bank collects the payment of the bill.

4. Discounting and Purchasing

Usually for the demand bills the term "discounting of bills" is used, whereas the term "purchasing of bills" is usually used for "usance bills". The bank immediately credits the customer's account in both the cases with the amount of the bill less its charges.

In case of "purchasing of bill" the charges are less as the bank can accumulate the payment immediately by giving the bill to the drawee for payment. But for, discounting of bill the charges are higher as the bank charges includes the charges for services rendered and also the interest for the period from the date of discounting the bill to the date of its maturity. Apart from this, when bills are dishonoured certain charges are incurred and in such cases the bank will debit the account of the customers with the amount of the bill along with interest and other charges.

5.5.2 Advantages of Bill Discounting

Q28. What are the advantages of bill discounting.

Ans :

The following are the advantages of bill discounting to investors and banks and finance companies.

1. To Investors

The advantages of bill discounting to investors are as follows,

- (i) Bill discounting acts as the short-term source of finance to the investors.
- (ii) Bill discounting is a type of a transaction and is not included under section 370 of the Indian companies Act 1956, which usually limits the amount of loan that can be offered by group companies.
- (iii) From both the cash flow and companies perspective the tax at source is not deducted at the time of making the payment charges which is very accessible or appropriate (as bill discounting is not a lending).
- (iv) The discount rates are better than the rates which are available on ICDs

- (v) There is a flexibility in the quantum of investments as well as in the duration of investments.

2. To Banks

The advantages of bill discounting to banks and finance companies are as follows:

(i) Safety of Funds

A banker can easily enforce his claim, as bill of exchange is a negotiable instrument bearing signatures of the two concerned parties which is considered as good for the amount of bill.

(ii) Certainly of Payment

A bill of exchange is considered as a self-liquidating asset which is possessed by the banker and helps the banker to know in advance the date of its maturity. The bill finance eliminates the need for maintaining large, unutilised and ideal cash balances. It facilitates the banks to have greater control over their withdrawals.

(iii) Profitability

As discount on a bill is front ended, the profit is greater than other loans and also advances in which the interest is usually paid on the quarterly or half yearly basis.

(iv) Eliminates Inter-bank Liquidity Problems

The development of healthy parallel bill discounting market helps in stabilizing the unusual changes in the call money market as banks can buy and sell bills to eliminate their liquidity mismatches.

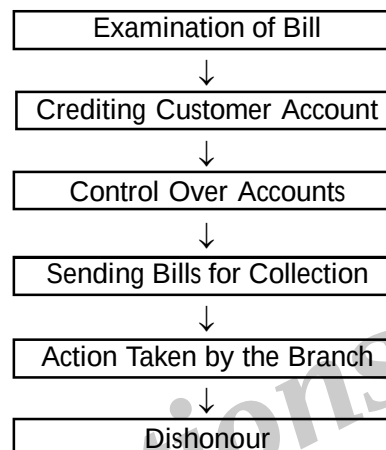
3. Discount Rate and Effective Rate of Interest

The banks and finance companies which are discounting the bill opts to discount the letter of credit L/C backed bills when compared to the clean bills, as the rate of discount which is applied to clean bills is more than the rate which is applied to L/C backed bills. In such type of bills, the discount is payable in advance but the effective rate of interest is more than the specified rate. The discount rate changes frequently based on the short-term interest rate.

Q29. Outline the process of bill discounting.

Ans :

The different steps which are involved in the discounting and purchasing of commercial bills of exchange are as follows,



1. Examination of Bill

Generally, the nature of the bill and the transaction is verified by the banker. The banker then assures that the customer has supplied all the needed documents along with the bill.

2. Crediting Customer Account

Once the authenticity of the bill is verified, the banker offers a credit limit either on regular or on a specific basis. The customers account is credited with the net amount of the bill and the discount amount is the income earned by the bank on discounting/purchasing. The bank takes the amount of bill as advance.

3. Control Over Accounts

A completely separate register is kept for recording the amount availed by each customer in order to assure that the customers does not borrow more than the sanctioned limit.

Separate columns are made for displaying the names of customers, limits sanctioned, bills discounted, bills collected, loans granted and loans repaid. This helps in knowing the limit utilized by the customer easily.

4. Sending Bills for Collection

The bill along with the documents which are duly stamped by the banker is sent to the branch of a banker for formally introducing the bill for acceptance or payment as per the instructions that are accompanied along with the bill.

5. Action Taken by the Branch

The collecting banker after receiving the payment remits the payment to the banker which was sent the bill for collection.

6. Dishonour

In case of dishonor the drawer of the bill receives the dishonor advice. It will be more suitable for the collecting banker to obtain the bill which is protested for dishonor. The collecting banker or the branch of bank for such purpose keeps a separate register in which the particulars like date on which the bills are to be presented, the party to whom it is to be presented and so on are recorded. The banker then introduces them for acceptance or payment as needed. The customer account is debited by the banker with the amount of the bill and also the charges incurred because of dishonour of the bill. But this bill must not be purchased at the time at which it is presented again. The banker may however agree to accept it for collection.

Q30. Who are the parties involved in bill discounting ?

Ans :

The parties who are involved in bill discounting are as follows,

1. Drawer

The drawer is a person who sells the bill at a rate of discount to due bank when the money is needed before the maturity of bill.

2. Bank

The bank accepts the bill at a specific rate of interest or discount from drawer for certain number of days.

3. Acceptor

The acceptor is the person to whom the bank presents the bill for availing the cash payment. The acceptor is also known as drawer.

In commercial bill financing, there are two systems of bills i.e., the drawer bill system and the drawee bill system.

(a) Drawer Bills System : The characteristics of 'drawer bills system' are as follows,

- (i) The sellers of goods draws the bills on the buyers of the goods.
- (ii) For the drawee of the bills the bills are discounted or purchased.
- (iii) The banker basically takes into account the credit of the drawer of the bill, at the time of discounting or purchasing these bills.

Drawer bills system is very popular in India.

(b) Drawee Bills System : The characteristics of drawee bill system are as follows,

- (i) At the instance of the buyer the drawer the banker accepts the bill drawn by the seller.
- (ii) The banker provides support based on the strength of the creditworthiness of the buyer.

Drawee bill system is classified into the types which are as follows :

(i) Acceptance Credit System

In this system, the banker of the buyer accepts the bill of exchange which is made for the goods purchased by the drawee. This type of bill can be drawn on the buyer or on the banker. The banker wants the borrower to show the goods which are purchased under the acceptance credit in periodical stock statements that are submitted to the banker.

(b) Bill Discounting System

In this system, a bill is directly drawn on buyers bank by the seller. The buyers bank then

discounts the bill and the proceeds are sent to the seller. The buyers banker will show the bills as "bill discounted".

In both the systems, the record of bills is maintained by the banker (both accepted and still outstanding bills). This is to make sure that the advance which is sanctioned with not cross the credit limit.

5.6 FACTORING - MEANING

Q31. Define term factoring.

Ans :

Meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done'. According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

- i) **According to Robert W. Johnson** in his book 'Financial Management' states, "factoring is a service involving the purchase

by a financial organisation, called a factor, of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities".

- ii) **According to V.A. Avadhani**, "factoring is a service of financial nature involving the conversion of credit bills into cash".
- iii) **According to Kohok**, "factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods".
- iv) **According to Prof. S.P. Singh**, a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that "factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance.

Q32. What are the functions of factor?

Ans :

Factor is a financial institution that specialises in buying accounts receivables from business firms. A factor performs some important functions. These may be discussed as follows:

1. Provision of finance

Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally a factor gives about 80% of the value of receivables as advance to the client. Thus the nonproductive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.

2. Administration of sales ledger

The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the

specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables and the amount received from customers. Thus the factor undertakes the responsibility of entire sales administration of the client.

3. Collection of receivables

The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.

4. Protection against risk

If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.

5. Credit management

The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc. In this way the factor advocates the best credit and collection policies suitable for the firm (client). In short, it helps the client in efficient credit management.

6. Advisory services

These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide

experience in the field of finance. It is a specialised institution for managing account receivables. It possesses extensive credit information about customer's credit worthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

5.6.1 Nature of Factoring

Q33. Explain the nature (or) features of factoring.

Ans :

From the following essential features of factoring, we can understand its nature:

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The factor purchases the credit/receivables and collects them on the due date. Thus the risks associated with credit are assumed by the factor.
3. A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).
4. A factor specialises in handling and collecting receivables in an efficient manner.
5. Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.
6. Factoring is a technique of receivables management. It is used to release funds tied up in receivables (credit given to customers) and to solve the problems relating to collection, delays and defaults of the receivables.

5.6.2 Parties in Factoring**Q34. Explain the parties involved in factoring?****(or)****Explain the mechanism of factoring.****Ans :****1. The Buyer**

- (a) The terms of purchasing the material with the seller are negotiated by the buyer.
- (b) For making payment to the factor on due date the buyer receives the delivery of goods with invoice and instructions by the seller.
- (c) The buyer makes payment to factor on time or gets extension of time or in case of default it is influenced by the legal process of factor.

2. The Seller

- (a) A seller enters into a Memorandum of Understanding (MOU) with the buyer in the form of letter which is exchanged between them or an agreement entered into between them.
- (b) The seller sells goods to the buyer according to the MOU.
- (c) The seller performs different activities such as delivers copies of invoice, delivery challan, MOU and gives instructions for making payment to factor which given to buyer.
- (d) The seller for selling the receivables from the buyer to him receives 80 percent or more payment in advance from the factor.
- (e) After deducting the factors service charges etc., the seller receives balance payment from the factor.

3. The Factor

- (a) For the purpose of rendering the factor services, the factor enters into an agreement.
- (b) After receiving the copies of sale documents a payment of 80 percent of the price of the debt, is made to the seller.

- (c) The factor receives payment from the buyer mostly on due dates and after making usual deductions the money is transferred to the seller.
- (d) The factors also assures that the following conditions must be met for influencing the factoring arrangements,
 - (i) The documents which are drawn by the seller such as invoice, bills or other documents must include a clause that these payments existing from the transaction are referred to or specified in, must be factored.
 - (ii) The seller must ensure in writing to the factor that all the payments existing from these bills are free from any encumbrances, charge, lien, pledge, hypothecation or mortgage or right of set-off or counter-claim from others and so on.
 - (iii) The seller who is in favour of the factor must execute an assignment deed to allow him to recover the payment on time or after default.
 - (iv) The seller must ensure that all the conditions of sell-buy contract between him and the buyer have been followed and the transactions are completed.
 - (v) The seller must receive a letter of waiver from a bank for factor if the bank has control over the assets which are sold to the buyer and the sale proceeds must be deposited in the bank account.

5.6.3 Merits and Demerits of Factoring**Q35. What are the merits and Demerits of Factoring.****Ans :****Merits of factoring**

A firm that enters into factoring agreement is benefited in a number of ways. Some of the important benefits of factoring are summarised as follows:

1. Improves efficiency

Factoring is an important tool for efficient

receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.

2. Higher credit standing

Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.

3. Reduces cost

The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.

4. Additional source

Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

5. Advisory service

A factor firm is a specialised agency for better management of receivables. The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.

6. Acceleration of production cycle

With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.

7. Adequate credit period for customers:
Customers get adequate credit period for payment of assigned debts.

8. Competitive terms to offer

The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

Demerits of Factoring

The main limitations of factoring are outlined as below:

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.
5. Factoring may impose constraints on the way to do business. For non - recourse factoring most factors will want to pre- approve customers. This may cause delays. Further, the factor will apply credit limits to individual customers.

Q36. Classify the different types of factoring.

Ans :

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

- (i) Full service factoring or without recourse factoring

- (ii) With Recourse Factoring
- (iii) Maturity Factoring
- (iv) Bulk Factoring
- (v) Invoice Factoring
- (vi) Agency Factoring
- (vii) International Factoring

(i) Full service Factoring

Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since he assumes the credit risk also. He can not pass on this responsibility to his client and, hence, this type of Factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges'.

(iii) Maturity Factoring

Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount collected less factoring fees is paid to the client immediately. Hence it is also called 'collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as "Disclosed Factoring" or "Notified Factoring".

(v) Invoice Factoring

Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc. have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called 'Confidential Invoice Discounting' or 'Undisclosed Factoring'.

(vi) Agency Factoring

The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows:

- (i) The client has to look after the sales ledger administration and collection work and
- (ii) The factor has to provide finance and assume the credit risk.

(vii) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(vii) Suppliers Guarantee Factoring

This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix) Limited Factoring

Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer Based Factoring

In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected Buyer Based Factoring.

(xi) Seller Based Factoring

Under this type/the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called 'Selected Seller Based Factoring'.

Q37. Distinguish between factoring and discounting.

Ans :

Factoring differs from discounting in many respects. They are :

- (i) Factoring is a broader term covering the entire trade debts of a client whereas discounting covers only those trade debts which are backed by Accounts receivables.
- (ii) Under factoring, the factor purchases the trade debt and thus becomes a holder for value. But, under discounting the financier acts simply as an agent of his customer and he does not become the owner. In other words, discounting is a kind of advance against bills whereas factoring is an outright purchase of trade debts.
- (iii) The factors may extend credit without any recourse to the client in the event of non-payment by customers. But, discounting is always made with recourse to the client.
- (iv) Account receivables under discount are subject to rediscounting whereas it is not possible under factoring.
- (v) Factoring involves purchase and collection of debts, management of sales ledger, assumption of credit risk, provision of finance and rendering of consultancy services. But, discounting involves simply the provision of finance alone.
- (vi) Bill discounting finance is a specific one in the sense that it is based on an individual bill arising out of an individual transaction only. On the other hand, factoring is based on the 'whole turnover', i.e., a bulk finance is provided against a number of unpaid invoices.
- (vii) Under discounting, the drawee is always aware of the bank's charge on receivables. But, under undisclosed factoring everything is kept highly confidential.
- (viii) Bill financing through discounting requires registration of charges with the Registrar of Companies. Infact, factoring does not require such registration.

- (ix) Discounting is always a kind of “in-balance sheet financing”. That is, both the amount of receivables and bank credit are shown in the balance sheet itself due to its ‘with recourse nature. But, factoring is always “off - balance sheet financing”.

Q38. Describe the methods of evaluation used in factoring.

Ans :

The methods which are for evaluating the effectiveness of factoring finance are as follows,

1. Next benefit method and
2. Effective rate of interest method.

1. Next Benefit Method

Factoring is treated as a feasible short-term financing option, if the expected benefits are more than the expected costs. In this method, the desirability of factoring is ascertained based on the net benefit occurring from it.

Net benefit = Expected benefits > Expected costs

The following are some of the expected benefits of factoring,

- (a) Cash discount earned on the credit payments made by the customers.
- (b) Interest which avoided on non-factoring funds.
- (c) Bad debt losses which are avoided on credit sales.
- (d) The cost of credit administration which is avoided.
- (e) The contribution on incremental sales.

The following are some of the expected costs of factoring,

- (a) Factoring commission
- (b) Factoring discount/interest
- (c) Interest on own funds which are invested in receivables.

2. Effective Rate of Interest Method

In this method, the decision relating to

factoring is made based on the effective rate of interest which is incurred due to factoring by the firm. Effective rate of interest is calculated as follows,

$$\text{Effective rate of interest} = \frac{\text{Net factoring cost} \times 100}{\text{Net factor advance}}$$

Factoring is treated as feasible only if the effective rate of interest of the firm is less than the other sources of short term finance.

Q39. Explain the legal aspects of financial evaluation of factorial services.

Ans :

India does not have any codified legal framework/ code for controlling the factoring services. Factoring contract is regulated under the law of contract. The terms of factoring contract which is entered before starting the factoring process determines the legal relationship existing between a factor and a client. The following are some of the contents of a factoring agreement and the legal obligations of the parties,

1. The client offers an undertaking to the factor to sell and the factor agrees to purchase the receivables in accordance with the terms and conditions specified in the agreements.
2. The client gives guarantee that the receivables are valid, enforceable, undisputed and recoverable. The client also settles the disputes, damages and deductions related to the bills assigned to the factor.
3. The client gives the notices of assignments in the specified form to all these customers whose receivables are factored.
4. The client feels that the bills purchased by the factor on the basis of non-recourse will occur from the transactions that are approved by the factor or those which occurs under the credit limits authorized by the factor.
5. The factor gets the power of attorney for assigning the debts and for drawing the negotiable instruments with regard to such debts.
6. The client is ready to offer copies of invoices, credit notes and so on related to the factored accounts, to the factor, and the factor would

- ultimately remit the received amount against the factored invoices to the client.
7. The agreement clearly specifies the time limit and the agreement termination mode.
 8. Legally, the factor is considered as an assignee. The defence which the customer has against the factor is same like the defence which the customers have against the client.
 9. The customer is sometimes under a legal obligation to remit or transfer the amount directly to the factor but if he fails, then in such case he will not be discharged from his obligations to pay the factor (even if he pays directly to the client) till the client remits the amount to the factor.
 10. The factor needs a letter of disclaimer from the bank before factoring a receivable.
 11. It is very essential for the factor to assure that the book debts which it manages are free from any impediments which would authorise others to the money due. The firm should provide guarantee that the book debts are free from any rights of a third party in the factoring agreement.
 12. The factor has to recover the money which is due on an invoice. The agreement must specify that the factor should promptly act in his own name whenever required.
 13. Factoring agreement will comprehensively specify the way in which the firm has to be paid.
 14. The factoring offers an insurance to the firms against those customers who does not make payments. This will rely on determining whether the debt is approved or not which is basically decided before starting the factoring process.
 15. The factoring agreements specifies that the payment to the factor should be made by the customer directly. In case if a customer pays the amount to the client by mistake, then the agreement states that the firm must hold the money for the factor. In case it a firm does not holds the money then it will be breach of trust and the firm may be liable for losses.
 16. Some warrants that are needed are as follows,
 - (i) The firm needs to disclose the material facts which may influence the decision of a factor to approve a debt.
 - (ii) The firm needs to even warrant that the invoices sent for factoring signifies an adequate debt for the goods supplied.
 17. In case of disputed debts, the factor requires the customer to notify it immediately. A firm is expected to return back the advances which are made to it with regard to the disputed debt.
 18. The factor has the power to examine the books and accounts of a firm and the factoring arrangement period is specified in the agreement.
 19. The client will,
 - (i) Have a factor which acts as the role factor.
 - (ii) Give a satisfactory assignment along with actual invoices and evidence on delivery.
 - (iii) Submit all the sales to the factor before shipping for credit approval.
 - (iv) Provide a warranty that every customer has received his merchandise and will accept it without any dispute and claim.
 - (v) Give the right to the factor to hold the balances of credit as security for any debts owed by the client to the factor.
 20. The factor will,
 - (i) Purchase the bonafide accounts receivable which it has approved previously.
 - (ii) Charge interest on the sums advanced at a specific defined interest rate.
 - (iii) Render a statement of account monthly.
 - (iv) Advance against the purchase price, and will remit the balance on the monthly average due date of the receivables allotted along with 5 to 10 days for collection.

The legal implications of factoring are as follows,

- (i) The factor needs to, firstly determine whether there is a genuine underlying trade transaction or not, if a customer presents a bills of exchange or hundi along with his invoice.
- (ii) The factor should also examine with the banker of a client for assuring that there is no double financing.
- (iii) The factoring needs to provide contingency and for ensuring against default, the factor must obtain a personal guarantee of the proprietor or the directors of the company.
- (iv) The interest of the factor relating to the assignment of book debts of clients is protected by the provisions of section 130 of the Transfer of Property Act.

Q40. Explain the problems of factoring services in India.

Ans :

In India, the factoring services are at the initial stage so their quantitative growth is very limited and its future rely on the abolition of several genuine operational problems/ barriers which are as follows,

1. Credit Information

There is no authentic source of information available for factors so they have to rely on their own database for evaluating the credit of the clients. The system of multiple data bases formed by individual factors is expensive and lacks uniformity which is a serious obstacle in the growth of factoring service. The development of specialized credit information agency is needed urgently.

2. Stamp Duty

The stamp duty which is charged by the states is influenced by debt assignment, the stamp duty is more than 15 percent on the amount which is more than ₹ 2 lakh. It increases the cost of operations of service and minimizes the profitability of the factors. A very strong case is available for waiving the stamp duty on the assignment of debt factors.

3. Legal Framework

The kalyansundaram Committee suggested that changes are to be made in the other parts of the present legal framework for assuring that the factoring attains success in India.

4. Funding

In India, the factors are not allowed to access extensive funding sources on scales provided for other finance companies. The virtual dependence on equity funds, does not allow them to have optimal funding. In order to have cost effective financing of these companies, there is an urgent need to have greater access to the debt and money markets such as leasing and other finance companies.

5. Disclaimer Certificate

A factor requires a disclaimer certificate from banks for purchasing a book debt of its clients. In the present scenario, they are not willing to issue such a certificate, hence the factoring companies must be allowed to purchase book debts without need in such certificate from banks.

6. Limited Coverage

In, India, only domestic factoring of the advance with recourse is allowed and offered. Even though, ECGC and SBI FACS have introduced various measures for export factoring, headway has not been made. Hence, it is necessary and is the right time to offer export factoring to Indian exporters.

5.7 FORFEITING

Q41. Define the term Forfeiting.

Ans :

Introduction

Generally there is a delay in getting payment by the exporter from the importer. This makes it difficult for the exporter to expand his export business. However, for getting immediate payment, the concept of forfeiting shall come to the help of exporters.

The concept of forfaiting was originally developed to help finance German exports to Eastern block countries. In fact, it evolved in Switzerland in mid 1960s.

Meaning of Forfaiting

The term 'forfait' is a French word. It means 'to surrender something' or 'give up one's right'. Thus forfaiting means giving up the right of exporter to the forfaitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without recourse' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money. Under forfaiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount. Here the exporter passes to the forfaitor all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately. Thus he gets the benefit of cash sale. However, the forfaitor deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfaitor. The forfaitor may be a bank or any other financial institution.

In short, the non-recourse purchase of receivables arising from an export of goods and services by a forfaitor is known as forfaiting.

Forfaiting is not the same as international factoring. The tenure of forfaiting transaction is long. International factoring involves short term trade transactions. In case of forfaiting, political and transfer risks are also borne by the forfaitor. But in international factoring these risks are not borne by the factor.

Definition

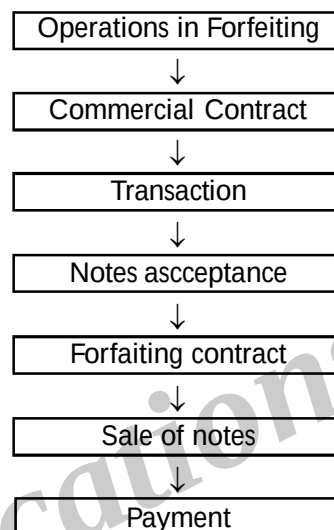
Forfaiting has been defined as "the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services".

5.7.1 Parties to Forfeiting

Q42. Explain the process of to forfeiting.

Ans :

The following steps are followed for operations in forfeiting,



Step-1: Commercial Contract

A contract is made between the buyer and the seller, which includes various basic terms like the forfeiting cost, margin to cover risk, commitment cost, grace days, fee to compensate the forfeiter for loss of interest because of transfer and payment delays, forfeiting period, repayment instalment, interest rate and so on. The factoring cost depends on the term of the bill, the denominated currency, the credit rating, the nation, importer's risk and so on.

Step-2: Transaction

The seller sells and delivers the goods to the buyer on the deferred payment system.

Step-3: Notes Acceptance

The buyer accepts the promissory notes in favour of seller for payment inclusive of the interest charges. These notes are then sent to the seller. Bank guarantee with respect to the promissory note is also acquired.

Step-4: Forfeiting Contract

The seller and the, forfeiting agent signs a forfeiting contract, along with the forfeiter which is mostly re-owned bank inclusive of the seller's bank.

Step-5: Sale of Notes

The seller sells the note or a bill to the forfeiter at a discount without recourse

Step-6: Payment

The seller makes the payment to the forfeiter as the face value of the note or bill, with less discount. The forfeiter can keep these notes or bills upto their maturity for making payment by the importer's bank or securities them for selling them as short-term high-yielding unsecured paper in the secondary market.

5.7.2 Cost of Forfeiting**Q43. Explain the Cost of Forfeiting.**

Ans :

The cost of forfaiting finance is always at a fixed rate of interest which is usually included in the face value of the bills or notes. Of course, it varies depending upon the arrangements duration, credit worthiness of the party, the country where the importer is staying, the denomination of the currency in which the export deal is to be done and the overall political, economic and monetary conditions prevailing in the importer's country. Since the forfaitor has to assume currency fluctuation risk, interest rate fluctuation risk and the country's risk, he charges a fee and obviously it varies according to the risk factor involved in the deal.

Q44. What are the characteristics of forfeiting.

Ans :

The main characteristics of forfeiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'aval').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.

5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

5.7.3 Benefits of Forfeiting for Exporters and Importers**Q45. What are the Benefits of Forfeiting for Exporters and Importers.**

Ans :

(i) Profitable and Liquid

From the forfeiter's point of view, it is very advantageous because he not only gets immediate income in the form of discount charges, but also, can sell them in the secondary market or to any investor for cash.

(ii) Simple and Flexible

It is also beneficial to the exporter. All the benefits that are available to a client under factoring are automatically available under forfaiting also. However, the greatest advantage is its simplicity and flexibility. It can be adopted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and the forfaitor.

(iii) Avoids Export Credit Risks

The exporter is completely free from many export credit risks that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations or any political upheaval that may affect the collection of bills. Forfaiting acts as an insurance against all these risks.

(iv) Avoids Export Credit Insurance

In the absence of forfaiting, the exporter has to go for export credit insurance. It is very costly and at the same time it involves very cumbersome procedures. Hence, if an exporter goes for forfaiting, he need not purchase any export credit insurance.

(v) Confidential and Speedy

International trade transactions can be carried out very quickly through a forfaitor. It does not involve much documentary procedures. Above all, it is very confidential. The speed and confidentiality with which deals are made are very beneficial for both the parties namely the exporter and the importer. No banking relationship with the forfaitor is necessary, since, it is a one time transaction only.

(vi) Suitable to all Kinds of Export Deal

It is suitable to any kind of goods — whether capital goods exports or commodity exports. Any export deal can be subject to forfaiting.

(vii) Cent per cent Finance

The exporter is able to convert his deferred transaction into cash transaction through a forfaitor. He is able to get 100 per cent finance against export receivables.

(viii) Fixed Rate Finance

Forfaiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

Q46. What are the limitations of forfeiting.

Ans :

(i) Non-availability for Short and Long Periods

Forfaiting is highly suitable to only medium term deferred payments. Forfaitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short term and long term credit have to seek some other alternative source.

(ii) Non-availability for Financially weak Countries

Similarly, forfaitors generally do not come forward to undertake any forfeit financing

deal involving an importer from a financially weak country. Generally, the forfaitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be undertaken at a higher price.

(iii) Dominance of Western Currencies

In International forfaiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutsche Mark and French and Swiss Francs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in Procuring International Bank's Guarantee

Forfaitors do not normally finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfaitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

Q47. Explain the forfeiting scenario in India.

Ans :

Forfaiting, as a source of finance, has gained substantial momentum abroad.

- Though it had its origin in 'Zurich', it has been well established in all the financial centres of the world. Some of the important forfaiting centres are London, Zurich, Hong Kong, Singapore and Frankfurt. It has become a popular source of finance among Europeans.
- In India, forfaiting is slowly emerging as a new product in the liberalised financial market. It was approved by the Union Government only in January, 1994.
- The existing scheme available for exporters like concessional finance by commercial banks, insurance cover against export credit risks by ECGC etc. are available mainly to large and well established exporters. In this context, forfaiting may be a real boon to the small, as well as, new exporters.

- In India, forfaiting is done by the EXIM Bank. The minimum value of a forfaiting transaction is Rs. 5,00,000/-.
- A special form of promote/Bill has to be used for forfaiting transactions. An Indian exporter who wants to avail of this service has to approach the EXIM bank through his bank.
- The EXIM Bank would obtain the forfaiting quotation from the forfaiting agency abroad. Based on this, the exporter would work out his price to be quoted to the importer.
- If the importer accepts the price and the payment terms, the contract would be finalised and executed.
- The exporter would then get cash through forfaiting arrangements for which he has to enter into a separate contract with the forfaitor through the EXIM bank.
- However, in order to encourage forfaiting finance business, it is necessary to designate export contracts in leading international currencies.
- In the wake of economic liberalisation and opening'of our economy to the global market, there are good prospects for forfaiting business in India. To promote forfaiting business, it is essential that we should denominate our trade contracts in foreign currencies rather than in Indian rupees.
- Now, since the rupee has gained strength, it is time for us to denominate our trade obligations in foreign currencies so that the pace of forfaiting business may be accelerated mainly to boost our export trade.

Q48. "If factoring is for domestic trade, forfeiting is for international trade". Discuss bringing out the – similarities and dissimilarities between the two.

Ans :

The similarities between forfeiting and factoring is that they have similar characteristics of non-recourse dealing and advance payment.

Factoring and forfeiting differs in the following way,

S.No.	Basis	Factoring	Forfeiting
1.	Suitability	It is best suitable for short-term transactions.	It is best suitable, for medium-term transactions.
2.	Recourse	It can be carried out with or with-out recourse.	It is carried out without recourse only.
3.	Risk	The part of risk is transferrable to the exporter (seller).	No risk is transferrable. The forfeiter alone has to bear it.
4.	Cost	The seller bears the cost of factoring.	The forfeiting cost is incurred by the overseas buyer (importer).
5.	Coverage	It includes the complete set of jobs at a pre-determined price. the case-to-case basics.	The structuring and costing is carried out on
6.	Degree of financing	Merely a part of receivables factored is advanced by factoring.	It provides cent percent finance.
7.	Basis of financing	The financing relies upon the credit worthiness of the seller.	The financing relies upon the financial standing of the bank.
8.	Services	Apart from financing, factoring also offers various services like ledger administration and so on.	It is completely a financing arrangement.
9.	Exchange fluctuations	Factoring does not provide any security for the exchange rate fluctuations.	The forfeiter provides security against the exchange rate changes for a premium charge.
10.	Contract	The factoring contract is made between the seller and the factor.	The forfeiting contract is made between the exporter and the forfeiter.

Short Question and Answers

1. Define the term Merchant Banking.

Ans :

Meaning

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services.

The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking. We can define merchant banking as a process of transferring capital from those who own it to those who use it.

Definition

i) **According to Random House Dictionary**, "merchant bank is an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks".

ii) **According to SEBI (Merchant Bankers) Rules 1992**, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering corporate advisory services in relation to such issue management".

iii) In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

Thus merchant banking involves a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, preparation of feasibility reports etc. It is not

necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialise in one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

In short, merchant banking involves servicing any financial need of the client.

2. Objectives of merchant banking.

Ans :

1. To help for capital formation.
2. To create a secondary market in order to boost the industrial activities in the country.
3. To assist and promote economic endeavour.
4. To prepare project reports, conduct market research and pre-investment surveys.
5. To provide financial assistance to venture capital.
6. To build a data bank as human resources.
7. To provide housing finance.
8. To provide seed capital to new enterprises.
9. To involve in issue management.
10. To act as underwriters.
11. To identify new projects and render services for getting clearance from government.
12. To provide financial clearance.
13. To help in mobilizing funds from public.
14. To divert the savings of the country towards productive channel.
15. To conduct investors conferences.
16. To obtain consent of stock exchange for listing.
17. To obtain the daily report of application money collected at various branches of banks.
18. To appoint bankers, brokers, underwrites etc.
19. To supervise the process on behalf of NRIs for their ventures.

20. To provide service on fund based activities.
21. To assist in arrangement of loan syndication.
22. To act as an acceptance house.
23. To assist in and arrange mergers and acquisitions.

3. Define the term Venture Capital.

Ans :

Introduction

There are some businesses that involve higher risks. In the case of newly started business, the risk is more. The new businesses may be promoted by qualified entrepreneurs. They lack necessary experience and funds to give shape to their ideas. Such high risk, high return ventures are unable to raise funds from regular channels like banks and capital markets.

Generally people would not like to invest in new high risk companies. Some people invest money in such new high risk companies. Even though the risk is high, there is a potential of getting a return of ten times more in less than five years. The investors making such investments are called venture capitalists.

The money invested in new, high risk and high return firms is called venture capital. Venture capitalists not only provide money but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. They get good return on their investment. The percentage of the profits the venture capitalists get is called the carry.

Meaning of Venture Capital

The term venture capital comprises of two words, namely, 'venture' and 'capital'. The term 'venture' literally means a 'course' or 'proceeding', the outcome of which is uncertain (i.e., involving risk). The term capital refers to the resources to start the enterprise. Thus venture capital refers to capital investment in a new and risky business enterprise. Money is invested in such enterprises because these have high growth potential.

A young hi-tech company that is in the early stage of financing and is not yet ready to make a public issue may seek venture capital. Such a high

risk capital is provided by venture capital funds in the form of long term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

4. Features of Venture Capital.

Ans :

Some of the features of venture capital financing are as under :

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.
3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.
5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.

5. What are the characteristics of leasing?

Ans :

The following are the characteristics of a lease:

1. The Parties

Lease agreement involves two parties i.e., the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for

periodical rental payment for an agreed period (pre-determined) of time.

2. The Asset

Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery, building, and so on. In leasing the ownership of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lessor where as its use is being transferred to the lessee.

3. The Term

The term of lease agreement is known as lease period. It is considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Quite a few times the lease period is being divided into primary lease period and secondary lease period.

4. The Lease Rentals

Lease rentals form the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up such cost i.e., interest on the lessor's investment, any repairs and maintenance costs which form the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease.

6. Define the term financial lease.

Ans :

A financial lease is also known as Capital lease, Long-term lease, Net Lease and Close lease.

- In a financial lease, the lessee selects the equipments, settles the price and terms of sale and arranges with a leasing company to buy it. He enters into an irrevocable and non-cancellable contractual agreement with the leasing company.
- The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it.

➤ He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.

➤ The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain a non cancellable clause which means that the lessor transfers the title to the lessee at the end of the lease period.

➤ Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available.

➤ The leasing company also charges nominal service charges to cover legal and other costs.

➤ The leasing company may also insist on collaterals or bank's guarantee in individual cases.

➤ In a large number of cases, the financial leases are used as financing cum tax planning tool.

➤ The financial lease is very popular in India as in other countries like USA, UK and Japan.

➤ On an all India basis, at present, approximately a lease worth Rs. 75 to Rs. 100 crores is transacted as a tax planning device.

7. Define the term leverage lease.

Ans :

A leverage lease is used for financing those assets which require huge capital outlay.

- The outlay for purchase cost of the asset generally varies from Rs. 50 lakhs to Rs. 2 crore and has economic life of 10 years or more.
- The leverage lease agreement involves three parties, the lessee, the lessor and the lender.
- The lessor acquires the assets as per the terms of the lease agreement but finances only a

part of the total investment, say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor.

- The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments.
- The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease.
- In leveraged lease, a wide range of equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc. are acquired.
- Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment.
- By investing 20% or 25% of the cost of an asset, the lessor is entitled to 100% allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible.

8. Define the term discounting.

Ans :

Generally, a trade bill arises out of a genuine credit trade transaction.

- The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit.
- It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date.
- In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold.

- It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process.
- It is where the commercial banks enter into as a financier.

9. Define term factoring.

Ans :

Meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done'. According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

- i) **According to Robert W. Johnson** in his book 'Financial Management' states, "factoring is a service involving the purchase by a financial organisation, called a factor, of

receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities”.

- ii) **According to V.A. Avadhani**, “factoring is a service of financial nature involving the conversion of credit bills into cash”.
 - iii) **According to Kohok**, “factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods”.
-

10. Explain the Cost of Forfeiting.

Ans :

The cost of forfaiting finance is always at a fixed rate of interest which is usually included in the face value of the bills or notes. Of course, it varies depending upon the arrangements duration, credit worthiness of the party, the country where the importer is staying, the denomination of the currency in which the export deal is to be done and the overall political, economic and monetary conditions prevailing in the importer's country. Since the forfaitor has to assume currency fluctuation risk, interest rate fluctuation risk and the country's risk, he charges a fee and obviously it varies according to the risk factor involved in the deal.

Choose the Correct Answer

1. The functions of merchant bankers are, [d]
(a) Corporate counselling (b) Portfolio management
(c) Issue management (d) All the above
2. A person who agrees to take up party subscribed securities is, [a]
(a) Underwriter (b) Debenture trustee
(c) Portfolio manager (d) Registrar
3. Underwriter should subscribe the issue within _____ days of the date of receiving an intimation from the issuer. [c]
(a) 30 days (b) 60 days
(c) 45 days (d) 15 days
4. A type of lease where the lessor is not related to the repairs and maintenance of the leased asset is known as, [a]
(a) Net lease (b) True lease
(c) Full payout lease (d) Financial lease
5. Companies which enters into leasing business for the purpose of taking the advantage of huge depreciation and tax benefits is, [b]
(a) Specialized leasing companies (b) One-off lessors
(c) Manufacturer lessors (d) Financial institutions
6. Select the benefits for lessor. [d]
(a) Stable business (b) Second-hand market
(c) Wider distribution (d) All the above
7. The following are the step of the leasing process, [d]
(a) Lease selection (b) Lease contract
(c) Lease period (d) All the above
8. Parties involved in hire purchase transaction are, [c]
(a) Hirer (b) Hire-vendor
(c) Both (a) & (b) (d) Lessor
9. The initial amount paid in hire purchase transaction is known as, [a]
(a) Down payment (b) Interest
(c) Depreciation (d) Cost of asset
10. The main functions of a factor are [d]
(a) Administration of sales ledger (b) Financing trade debts
(c) Credit control and credit protection (d) All the above

11. The contract entered between the seller of goods and the factor is [a]
(a) Factoring contract (c) Lease contract
12. The people who take part in factoring services are [d]
(a) Buyer (b) Seller
(c) Factor (d) All the above
13. Full-service factoring is also known as [c]
(a) Collection factoring (b) Advance factoring
(c) Old-line factoring (d) Recourse factoring
14. Which of the following is not a service provided by factoring companies? [b]
(a) Credit insurance (b) Bond issuance facilities
(c) Sales ledger administration (d) Provision of finance
15. Bills that are drawn on Indian residents are known as [a]
(a) Inland bills (b) Foreign bills
(c) Clean bills (d) Supply bills
16. Easy access, safety of funds, certainty of payment and smooth liquidity are the benefits of [c]
(a) Hire purchase (b) Leasing
(c) Bill discounting (d) Factoring
17. The drawee bills system involves [c]
(a) Acceptance credit system (b) Bills discounting system
(c) Both (a) and (b) (d) Drawer bills system
18. The practise of discounting the accommodation bills is known as [b]
(a) Stamping bills (b) Kiteflying
(c) Hundi (d) None
19. The committees which are setup to examine the system of bank financing and money market are [d]
(a) Dahejia committee, 1969 (b) Tandon committee, 1974
(c) Chore committee, 1980 (d) All the above.

Fill in the blanks

1. An arrangement between a factor and his client is known as _____ .
2. _____ services are spin-offs of the close relationship between a factor and a client.
3. _____ is a fund based activity which emerged as a profitable business in the early nineties for finance companies.
4. In _____ factoring, the factor has right to recourse if the debt payable factored tends to be irrecoverable.
5. The factor makes the payment on a guaranteed payment date or on the date of collection in _____ .
6. The world factor is derived from the world _____ .
7. _____ is changed on the face value of the bill for the unexpired period of the bill.
8. The name of the proposed factor is mentioned on the face of the invoice made by the seller of goods is _____ .
9. _____ has constantly endeavoured to develop the commercial bills market.
10. A bill on which no time of payment or "due dates is specified in" known as _____ .
11. In _____ the ownership of asset is separated from economic use of an asset or equipment.
12. The consideration paid by the lessee as mentioned in the lease transaction is called as _____ .
13. In _____ the parties stays in different countries.
14. A means of financing the price of goods to be sold on a future date is _____.
15. _____, and _____ are included in taxation aspects of hire-purchase transactions.
16. The rate of interest which is charged in HP as a percent of the original cash price of the asset is _____.
17. _____ is the balance amount which is by the hirer after making the down payment.
18. _____ refers to the total holding of securities of an investor.
19. The marketing of corporate securities by offering then to the public is known as _____.
20. Portfolio managers have to obtain certificate of registration from the _____ to act as portfolio mangers.

ANSWERS

1. Factoring
2. Advisory
3. Bill discounting
4. Recourse
5. Maturity factoring
6. Facer
7. Discount
8. Disclosed factoring
9. Reserve bank of India
10. Demand bill
11. Leasing
12. Lease rentals
13. International lease
14. Hire-purchase
15. Income tax, sales tax and interest tax
16. Add-on rate of interest
17. Equated Monthly Installments (EMIs)
18. Portfolio
19. Issue management
20. SEBI

FACULTY OF COMMERCE
B.Com (CBCS) II - Semester Examination
(Common for General & Honours Courses)
Model Paper - I
BANKING AND FINANCIAL SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer any FIVE of the following questions

SECTION - A (5×4=20 Marks)

ANSWERS

- | | | |
|----|-------------------------------------|----------------------|
| 1. | What is core banking? | (Unit - I, SQA. 7) |
| 2. | Define monetary policy. | (Unit - I, SQA. 11) |
| 3. | Right of Lien. | (Unit - II, SQA. 4) |
| 4. | Characteristics of promissory note. | (Unit - III, SQA. 2) |
| 5. | What is collateral securities ? | (Unit - III, SQA. 9) |
| 6. | Define the term Financial Services. | (Unit - IV, SQA. 1) |
| 7. | Define the term Merchant Banking. | (Unit - V, SQA. 1) |
| 8. | Define the term financial lease. | (Unit - V, SQA. 6) |

SECTION - B - (5 × 12 = 60 Marks)

Note : Answer all the questions

- | | | |
|-----|---|------------------------|
| 9. | (a) (i) Define the term bank. Explain the features of banks. | (Unit - I, Q.No. 1) |
| | (ii) What is District Co-Operative Central Bank (DCCB)? | |
| | Explain the objectives of DCCB. | (Unit - I, Q.No. 28) |
| | (OR) | |
| | (b) (i) Explain the technologies enabling in mobile banking. | (Unit - I, Q.No. 12) |
| | (ii) Explain the features of development banks. | (Unit - I, Q.No. 38) |
| 10. | (a) State the Relationship Between Banker and Customer. | (Unit - II, Q.No. 2) |
| | (OR) | |
| | (b) Explain the procedure of opening in case of partnership firms. | (Unit - II, Q.No. 9) |
| 11. | (a) (i) What is Negotiable Instruments ? Explain the features of | |
| | Negotiable Instruments. | (Unit - III, Q.No. 1) |
| | (ii) Who is a paying banker? What are the Duties and Responsibilities | |
| | of Paying Banker ? | (Unit - III, Q.No. 17) |

(OR)

- (b) Write a short note on advances against stock exchange securities.
advances State the precautions to be taken by a banker while making
against stock exchange securities.

(Unit - III, Q.No. 23)

12. (a) Discuss briefly some of the Innovative Financial Instruments
introduced in recent times in the financial service sector.

(Unit - IV, Q.No. 9)

(OR)

- (b) What are the Challenges Faced by the Financial Service Sector ?

(Unit - IV, Q.No. 10)

13. (a) Explain the various Services of Merchant Bankers.

(Unit - V, Q.No. 3)

(OR)

- (b) (i) Outline the steps involved in leasing transactions.
(ii) Explain the parties involved in factoring?

(Unit - V, Q.No. 18)

(Unit - V, Q.No. 34)

FACULTY OF COMMERCE
B.Com (CBCS) II - Semester Examination
 (Common for General & Honours Courses)
Model Paper - II
BANKING AND FINANCIAL SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer any FIVE of the following questions

SECTION - A (5 × 4 = 20 Marks)

ANSWERS

- | | |
|--|----------------------|
| 1. Whao is a banking ombudsman? | (Unit - I, SQA. 9) |
| 2. Regional Rural Banks. | (Unit - I, SQA. 13) |
| 3. Define KYC. | (Unit - II, SQA. 6) |
| 4. Define Cheque. | (Unit - III, SQA. 4) |
| 5. Precautions in Advancing Against Goods. | (Unit - III, SQA. 8) |
| 6. Non-fund based activities. | (Unit - IV, SQA. 4) |
| 7. Features of Venture Capital. | (Unit - V, SQA. 4) |
| 8. Explain the Cost of Forfeiting. | (Unit - V, SQA. 10) |

SECTION - B - (5 × 12 = 60 Marks)

Note : Answer all the questions

- | | |
|--|-----------------------|
| 9. (a) (i) What are the various functions of commercial banks? | (Unit - I, Q.No. 6) |
| (ii) What are the Objectives RBI ? | (Unit - I, Q.No. 23) |
| (OR) | |
| (b) (i) What are the Objectives of RRBs ? | (Unit - I, Q.No. 33) |
| (ii) Explain the composition of IFCI. | (Unit - I, Q.No. 42) |
| 10. (a) Define KYC. Explain in detail about KYC norms suggested by RBI. | (Unit - II, Q.No. 4) |
| (OR) | |
| (b) Explain the conditions required for a joint stock companies during the opening of an account. | (Unit - II, Q.No. 10) |
| 11. (a) What do you understand by a accep- tance of a bill under the negotiable instrument Act 1881 and what are the modes of acceptance ? | (Unit - III, Q.No. 8) |

(OR)

- (b) Write a short note on advances against real estate. What are the causes of refusing real estate as security by a bank? State the precautions to be taken by a bank while lending money against the security of real estate.

(Unit - III, Q.No. 27)

12. (a) What are the functions of Financial Services.

(Unit - IV, Q.No. 4)

(OR)

- (b) Explain the various New Financial Products and Services.

(Unit - IV, Q.No. 8)

13. (a) Outline the process of bill discounting.

(Unit - V, Q.No. 29)

(OR)

- (b) (i) Distinguish between financial lease and operating lease.

(Unit - V, Q.No. 21)

- (ii) Explain the process of forfeiting.

(Unit - V, Q.No. 42)

FACULTY OF COMMERCE
B.Com (CBCS) II - Semester Examination
(Common for General & Honours Courses)
Model Paper - III
BANKING AND FINANCIAL SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer any FIVE of the following questions

SECTION - A (5 × 4 = 20 Marks)

ANSWERS

- | | |
|---|----------------------|
| 1. District Central Co-operative Bank | (Unit - I, SQA. 12) |
| 2. M-Banking. | (Unit - I, SQA. 5) |
| 3. Meaning of a Customer. | (Unit - II, SQA. 2) |
| 4. What is Negotiable Instruments ? | (Unit - III, SQA. 1) |
| 5. Define loans and advances. | (Unit - III, SQA. 6) |
| 6. Importance of Financial Services. | (Unit - IV, SQA. 2) |
| 7. Define the term Merchant Banking. | (Unit - V, SQA. 1) |
| 8. What are the characteristics of leasing? | (Unit - V, SQA. 5) |

SECTION - B - (5 × 12 = 60 Marks)

Note : Answer all the questions

- | | |
|--|------------------------|
| 9. (a) (i) What are the emerging trends in commercial banking in India? | (Unit - I, Q.No. 7) |
| (ii) Define monetary policy. What are the objectives of monetary policy ? | (Unit - I, Q.No. 25) |
| (OR) | |
| (b) (i) Explain the various Contemporary Banks in India. | (Unit - I, Q.No. 31) |
| (ii) Explain briefly about EXIM bank? | (Unit - I, Q.No. 44) |
| 10. (a) Explain in detail about opening of an account. | (Unit - II, Q.No. 5) |
| (OR) | |
| (b) Explain the risk in opening account in the name of a minor. | (Unit - II, Q.No. 7) |
| 11. (a) Who is collecting banker ? Discuss the duties and responsibilities of collecting banker. | (Unit - III, Q.No. 18) |

(OR)

- (b) What is collateral securities ? and what are the precautions to be taken loans against collateral securities. (Unit - III, Q.No. 29)
12. (a) Define the term Financial Services. What are the characteristics of Financial Services. (Unit - IV, Q.No. 1)
- (OR)**
- (b) Critically analyse the present position of the financial service sector in India. (Unit - IV, Q.No. 11)
13. (a) Define the term leasing. What are the characteristics of leasing? (Unit - V, Q.No. 15, 16)
- (OR)**
- (b) (i) Explain the nature (or) features of factoring. (Unit - V, Q.No. 33)
- (ii) What are the Benefits of Forfeiting for Exporters and Importers. (Unit - V, Q.No. 45)